Attachment 5

KPMG

COLUMBIA UNITED PROVIDERS, INC.

Statutory Financial Statements
and Schedules

December 31, 2009 and 2008

(With Independent Auditors' Report Thereon)

KPMG LLP
Suite 3800
1300 South West Fifth Avenue
Portland, OR 97201

Independent Auditors' Report

The Board of Directors
Columbia United Providers, Inc.:

We have audited the accompanying statutory statements of admitted assets, liabilities, and capital and surplus of Columbia United Providers, Inc. (the Company) as of December 31, 2009 and 2008, and the related statutory statements of revenues and expenses, changes in capital and surplus, and cash flows for the years then ended. These statutory financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As described more fully in note 2 to the statutory financial statements, the Company prepared these statutory financial statements using accounting practices prescribed or permitted by the Washington State Office of the Insurance Commissioner, which practices differ from U.S. generally accepted accounting principles. The effects on the statutory financial statements of the variances between the statutory basis of accounting and U.S. generally accepted accounting principles also are described in note 2.

In our opinion, because of the effects of the matter discussed in the preceding paragraph, the statutory financial statements referred to above do not present fairly, in conformity with U.S. generally accepted accounting principles, the financial position of Columbia United Providers, Inc. as of December 31, 2009 and 2008, or the results of its operations or its cash flows for the years then ended.

Also, in our opinion, the statutory financial statements referred to above present fairly, in all material respects, the admitted assets, liabilities, and capital and surplus of Columbia United Providers, Inc. as of December 31, 2009 and 2008, and the results of its operations and its cash flow for the years then ended, on the basis of accounting described in note 2.

KPMG LLP is a Delaware limited liability partnership, the U.S. member firm of KPMG International Cooperative ("KPMG International"), a Swiss entity

KPMG

Our audits were made for the purpose of forming an opinion on the basic statutory financial statements taken as a whole. The supplementary information included on the supplemental schedules 1 and 2 is presented for purposes of additional analysis and is not a required part of the basic financial statements. Such information has been subjected to the auditing procedures applied in the audit of the basic statutory financial statements and, in our opinion, is fairly stated in all material respects in relation to the basic statutory financial statements taken as a whole.

KPMG LLP

May 13, 2010

COLUMBIA UNITED PROVIDERS, INC.

Statutory Statements of Admitted Assets, Liabilities, and Capital and Surplus

December 31, 2009 and 2008

Admitted Assets		**2009**	**2008**
Bonds and stocks:			
Bonds	$	9,113,075	8,964,770
Common stock		309,054	225,150
Cash, cash equivalents and short-term investments		9,215,465	8,314,736
Uncollected premiums		1,795,172	1,599,778
Amounts receivable from uninsured health plans		25,720	10,948
Federal income tax refund receivable		1,045,187	—
Net deferred tax assets		209,167	157,020
Interest and other investment income due and accrued		71,020	106,199
Healthcare receivables		114,997	79,693
Receivables from reinsurers		270,876	851,134
Receivables from affiliate		391,231	289,700
Total admitted assets	$	22,560,964	20,599,128
Liabilities and Capital and Surplus			
Claims unpaid	$	6,572,751	6,954,199
Unpaid claims adjustment expense		232,363	156,815
Federal income tax payable		—	729,511
Other expenses due or accrued		1,184,206	1,132,962
Total liabilities		7,989,320	8,973,487
Common stock, $1 par value. Authorized 1,000,000 shares; issued and outstanding 29,415 shares and 29,596 shares at December 31, 2009 and 2008, respectively		29,415	29,596
Statutory surplus		3,000,000	3,000,000
Unassigned surplus		11,542,229	8,596,045
Total capital and surplus		14,571,644	11,625,641
Total liabilities and capital and surplus	$	22,560,964	20,599,128

See accompanying notes to statutory financial statements.

COLUMBIA UNITED PROVIDERS, INC.

Statutory Statements of Revenues and Expenses

Years ended December 31, 2009 and 2008

		2009	2008
Underwriting income:			
Premium income, net	$	96,935,429	84,367,231
Underwriting deductions:			
Hospital and medical expenses		83,267,472	71,286,010
Claims adjustment expenses		2,016,764	2,101,206
General administrative expense		7,666,442	6,687,730
Total underwriting deductions		92,950,678	80,074,946
Underwriting gain		3,984,751	4,292,285
Net investment income		251,111	396,582
Other income		165,439	177,816
Net income before federal income taxes		4,401,301	4,866,683
Federal income tax expense		1,416,811	1,007,357
Net income	$	2,984,490	3,859,326

See accompanying notes to statutory financial statements.

COLUMBIA UNITED PROVIDERS, INC.

Statutory Statements of Changes in Capital and Surplus

Years ended December 31, 2009 and 2008

Capital and surplus as of December 31, 2007	$	7,594,750
Net income		3,859,326
Change in net unrealized gains and losses on investments, net of tax		(8,186)
Change in net deferred tax asset		(661,396)
Change in nonadmitted assets		852,446
Change in paid in capital and surplus		(11,299)
Capital and surplus as of December 31, 2008		11,625,641
Net income		2,984,490
Change in net unrealized gains and losses on investments, net of tax		55,377
Change in net deferred tax asset		21,833
Change in nonadmitted assets		(97,597)
Change in paid in capital and surplus		(18,100)
Capital and surplus as of December 31, 2009	$	14,571,644

See accompanying notes to statutory financial statements.

COLUMBIA UNITED PROVIDERS, INC.

Statutory Statements of Cash Flows

Years ended December 31, 2009 and 2008

		2009	2008
Net cash flows from operations:			
Premiums collected	$	96,740,035	83,943,214
Benefit and loss-related payments		(83,068,662)	(72,007,082)
Commissions, expenses paid and aggregate write-ins for deductions		(9,571,186)	(9,048,829)
Net cash from underwriting		4,100,187	2,887,303
Investment income, net of investment expenses		397,422	496,753
Federal income taxes paid		(3,191,508)	(55,846)
Other income		165,439	177,816
Net cash from operations		1,471,540	3,506,026
Net cash flows from investments:			
Proceeds from investments		7,210,000	5,503,872
Purchases of investments		(7,469,437)	(5,446,856)
Net cash (used in) from investments		(259,437)	57,016
Net cash flows from financing and miscellaneous sources:			
Other (applications) sources		(311,374)	89,495
Net cash (used in) from financing and miscellaneous sources		(311,374)	89,495
Net increase in cash, cash equivalents and short-term investments		900,729	3,652,537
Cash, cash equivalents and short-term investments, beginning of year		8,314,736	4,662,199
Cash, cash equivalents and short-term investments, end of year	$	9,215,465	8,314,736

See accompanying notes to statutory financial statements.

COLUMBIA UNITED PROVIDERS, INC.

Notes to Statutory Financial Statements

December 31, 2009 and 2008

(1) Nature of Operations

Columbia United Providers, Inc. (CUP) was incorporated on July 23, 1993 pursuant to Chapter 23.86, Revised Code of Washington State as a nonprofit cooperative association. During 1997, the board of directors of CUP adopted a conversion plan, which resulted in the conversion of CUP into a for-profit corporation. The Washington State Office of the Insurance Commissioner approved this conversion on February 25, 1997, and amended articles of incorporation and articles of conversion were filed with the Office of the Secretary of State of Washington. CUP is a taxable entity subject to federal taxation applicable to C corporations. In connection with this purpose, CUP applied for and received registration to operate as a healthcare service contractor pursuant to Chapter 48.44, Revised Code of Washington State. CUP began operations effective October 1, 1993.

Southwest Washington Health System (SWHS) owns 89.5% of the CUP common stock currently outstanding. The remaining common shares are owned by various physician practitioners in the Vancouver, Washington area. As of December 31, 2009 and 2008, there were 1,000,000 common shares authorized and 29,415 and 29,596 common shares outstanding, respectively.

On March 19, 2010, the SWHS's Board of Trustees announced that the Boards of SWHS and PeaceHealth have agreed to enter a process of formal discussions regarding affiliation between the two healthcare organizations. The formal discussions will begin immediately, with the process continuing through 2010. PeaceHealth is a Bellevue, Washington-based not-for-profit healthcare system with medical centers, critical access hospitals, medical group clinics, and laboratories located in Alaska, Washington, and Oregon.

CUP contracts directly with various providers within its service area for the provision of medical and hospital services, pharmaceuticals, and other related services. CUP reimburses these providers on a capitated or fee-for-service basis, depending on the negotiated contract. Some providers may be minority owners of CUP stock or affiliates of CUP. Certain providers may be eligible for increased or decreased reimbursement rates based on actual medical expense ratios compared to predetermined criteria. As a result of these criteria, CUP disbursed $2,081,830 in increased reimbursement during 2009. No additional payments were made in 2008.

All of CUP's revenues are sourced from the State of Washington (the State). Management believes CUP's ability to operate profitably is subject to the State of Washington's ability to adequately fund the Healthy Options Program and the Basic Health Plan. These State contracts provide for changes to previously agreed-upon premium rates and other contractual provisions due to extenuating circumstances, as defined by the State. These circumstances include lack of sufficient resources available to the State to continue to reimburse contracting health plans at the previously agreed-upon rates. The State of Washington is currently projecting significant budget deficits through at least June 30, 2011. The State has notified health plans participating in their programs, including CUP, that reductions in premiums or level of health plan enrollment may occur in future periods due to the projected deficits. The extent of these possible reductions is unknown at this time, but could be significant to CUP's premiums, operating results, and financial position in 2010 and future periods. CUP participates in the Healthy Options and Basic Health Plan programs, which represent 88% and 12% of premiums earned in 2009 and 86% and 14% of premiums earned in 2008, respectively. These programs are administered by departments of the State of Washington.

As of December 31, 2009 and 2008, CUP had approximately 40,704 and 33,768 enrolled members for the Healthy Options Program, and 3,076 and 4,185 enrolled members for the Basic Health Plan, respectively.

As a result of recently enacted and pending federal healthcare reform legislation, substantial changes are anticipated in the United States healthcare system. Such legislation includes numerous provisions affecting the delivery of healthcare services, the financing of healthcare costs, reimbursement of healthcare providers, and the legal obligations of health insurers, providers, and employers. These provisions are currently slated to take effect at specified times over approximately the next decade. This federal healthcare reform legislation does not affect the 2009 statutory financial statements.

(2) Summary of Significant Accounting Policies

(a) Basis of Presentation

The accompanying statutory financial statements of CUP are prepared in conformity with accounting practices prescribed or permitted by the National Association of Insurance Commissioners (NAIC) and the Washington State Office of the Insurance Commissioner (OIC), which is a comprehensive basis of accounting other than U.S. generally accepted accounting principles (GAAP). Prescribed statutory accounting practices include a variety of publications of the NAIC, as well as state laws, regulations, and general administrative rules. Permitted statutory accounting practices encompass all accounting practices not so prescribed. CUP has no permitted statutory accounting policies that differ from prescribed statutory accounting practices.

The principal differences between financial statements prepared in accordance with statutory accounting principles (NAIC SAP) and those prepared under GAAP are as follows:

(i) Certain assets designated as "nonadmitted," principally certain nongovernmental accounts receivable, furniture and equipment, prepaids, and other assets not specifically identified as an admitted asset within the *Accounting Practices and Procedures Manual* are excluded from the accompanying statutory statements of admitted assets, liabilities, and capital and surplus and are charged directly to unassigned surplus. Under GAAP, such assets are included in the balance sheet.

(ii) Changes in deferred income taxes are recorded directly to unassigned surplus as opposed to being an item of income tax benefit or expense for GAAP financial reporting purposes. Admittance testing may result in a charge to capital and surplus for nonadmitted portions of deferred tax assets. Under GAAP reporting, a valuation allowance may be recorded against the deferred tax asset and reflected as an expense for financial reporting purposes.

(iii) Investments, other than investments in subsidiaries, are carried at values prescribed by the NAIC. GAAP requires investments, other than investments in subsidiaries to be classified as held-to-maturity, trading, or available-for-sale. Held-to-maturity securities are carried at amortized cost, trading securities are carried at fair value with the changes in fair value included in the statement of revenues and expenses, and available-for-sale securities are carried at fair value with the changes in fair value reflected as a separate component of surplus.

(iv) Negative cash is reported as a negative asset under NAIC SAP, while under GAAP it is recorded as a liability.

(v) The statement of cash flows differs in certain respects from the presentation required by GAAP, including the presentation of the changes in cash and short-term investments instead of cash and cash equivalents. Short-term investments include securities with maturities, at the time of acquisition, of 12 months or less. There is no reconciliation between net income and cash from operations for statutory purposes.

(vi) Comprehensive income is not presented.

The following table sets forth the reconciliation of equity at December 31, 2009 and 2008 under GAAP and capital and surplus reported for statutory insurance requirements:

		2009	2008
Equity – GAAP	$	14,998,878	11,956,580
Adjustments for statutory reporting purposes:			
Net unrealized losses on investments		4,029	2,727
Furniture and equipment, net of accumulated depreciation		(245,112)	(151,258)
Prepaids		(125,408)	(60,972)
Deferred tax assets		(60,743)	(119,584)
Other assets		—	(1,852)
Capital and surplus – statutory basis	$	14,571,644	11,625,641

The difference in net income under U.S. generally accepted accounting principles and net income reported for statutory insurance requirements is not material.

(b) Use of Estimates

The preparation of the statutory financial statements on the basis of accounting practices prescribed by the NAIC requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the statutory financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Significant items subject to such estimates include claims unpaid, unpaid claims adjustment expense, uncollected premiums, receivables from reinsurers, and other-than-temporary impairment of investments.

(c) Cash, Cash Equivalents, and Short-Term Investments

Cash, cash equivalents, and short-term investments consist of liquid investments with maturities of 12 months or less from the date of acquisition. Cash was $7,208,705 and $8,066,470 at December 31, 2009 and 2008, respectively. Cash equivalents, which include investments with remaining maturities of three months or less at the time of acquisition, are recorded at amortized cost and were $1,000,278 and $248,266 at December 31, 2009 and 2008, respectively. Short-term investments, which include investments with remaining maturities between 3 months and 12 months, are recorded at amortized cost and were $1,006,482 and $0 at December 31, 2009 and 2008, respectively. The carrying balance of cash, cash equivalents, and short-term investments approximates fair value.

At December 31, 2009, $577,786 of CUP's cash is pledged as collateral to the Washington State Office of the Insurance Commissioner as a surety deposit pursuant to Title 48 of the Revised Code of Washington.

CUP maintains its cash and cash equivalents in bank deposit accounts, which at times may exceed federally insured limits.

(d) ***Investments***

Bonds, other investments, and common stocks are stated at values prescribed by the NAIC as follows:

- Bonds not backed by other loans are principally stated at amortized cost using the effective-interest method.
- Common stocks are reported at market value as determined by the NAIC Securities Valuation Office and the related net unrealized capital gains (losses) are reported in unassigned surplus unless the loss is determined to be other than temporary. For stocks with no NAIC assigned value, estimated market value is based on quoted market prices.
- Realized capital gains and losses are determined using the specific-identification method. Changes in admitted asset carrying amounts of bonds and common stocks are credited or charged directly to unassigned surplus unless the loss is determined to be other than temporary.
- A decline in fair value of a security below cost that is deemed to be other-than-temporary is recorded as an impairment loss and is included in net (loss) income in the accompanying statutory statements of revenue and expenses. A new cost basis is then established for the security.

(e) ***Furniture and Equipment***

Furniture and equipment, which are nonadmitted assets, are recorded at cost. Depreciation is calculated on the straight-line method over the estimated useful lives of the assets as follows:

Asset type	Depreciable life (years)
Furniture and equipment	7
Data processing equipment	3 – 5

The cost of furniture and equipment sold or retired and the related accumulated depreciation are removed from the accounts, and the resulting gain or loss is recorded. Maintenance and repairs are expensed as incurred. Depreciation expense recorded for the years ended December 31, 2009 and 2008 was $105,952 and $109,346, respectively.

(f) ***Claims Unpaid and Unpaid Claims Adjustment Expense***

The liability for claims unpaid includes claims in process and an estimated liability for incurred but not reported claims by physicians, hospitals, and other healthcare providers for services rendered to CUP's members. The claims unpaid liability is determined using actuarial estimates.

CUP has accrued an estimate for the amount needed to process its unpaid claims liability of $232,363 and $156,815 at December 31, 2009 and 2008, respectively, which is included in unpaid claims adjustment expense on the accompanying statutory statements of admitted assets, liabilities, and capital and surplus.

Management believes that the estimated liabilities for claims unpaid and the related claims adjustment expense at December 31, 2009 and 2008 are adequate to cover the ultimate liabilities; however, due to uncertainties inherent in the estimation process, there is at least a reasonable possibility that such estimates may be more or less than the amount ultimately paid when the claims are settled.

(g) ***Premium Income and Uncollected Premiums***

Premium income consists of premiums paid by the State of Washington for healthcare services. Premium income is received on a prepaid basis and is recognized as revenue during the month for which the premium is associated.

Uncollected premiums consist of amounts due from a department of the State of Washington for maternity case rates and newborn premiums due under the Healthy Options and Basic Health Plan contracts. The balance of uncollected premiums is periodically evaluated for collectibility in accordance with statement of statutory accounting principles (SSAP) No. 84, *Certain Health Care Receivables and Receivables Under Government Insured Plans*. If it is determined that a balance is uncollectible, the balance is written off and charged to income in the period the determination is made.

(h) ***Healthcare Receivables***

CUP has established a receivable for pharmaceutical rebates in accordance with SSAP No. 84 as of December 31, 2009 and 2008 in the amounts of $114,997 and $79,693, respectively. Such amounts are included in healthcare receivables on the accompanying statutory statements of admitted assets, liabilities, and capital and surplus. Recorded balances are estimates based on experience of actual rebates received within 90 days of billing. Balances not collected within 90 days of billing are not admitted.

(i) ***Reinsurance (Stop-Loss Insurance)***

CUP has stop-loss reinsurance indemnifying it against the cost of providing services to individual enrolled participants at 90% in excess of $125,000 for hospital charges up to a maximum of $1,000,000 per contract year for each enrolled member.

Stop-loss premium expense of $583,550 and $807,444 is included in net premium income for 2009 and 2008, respectively. Receivable from reinsurers was $270,876 and $851,134 as of December 31, 2009 and 2008, respectively, in the accompanying statutory statements of admitted assets, liabilities, and capital and surplus. Recoveries were $284,179 and $1,040,300 in 2009 and 2008, respectively, and were recorded as a reduction to hospital and medical expenses.

CUP cedes insurance to reinsurers in the ordinary course of business for the purpose of limiting exposure to large losses. Amounts recoverable from reinsurers are estimated in a manner consistent with the related claim liability. CUP evaluates the financial condition of its reinsurer and monitors risks arising from activities or economic characteristics of the reinsurer to minimize its exposure to losses from reinsurer insolvencies. If the reinsurers are unable to meet their obligations under such agreements, CUP would be liable for such default amounts. At December 31, 2009, substantially all reinsurance receivables were due from a single reinsurer.

(j) Income Taxes

CUP is subject to federal income taxes. Income taxes are provided for the tax effects of transactions reported in the statutory financial statements.

Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in unassigned surplus in the period that includes the enactment date.

The admissibility of CUP's deferred tax assets is determined according to NAIC SAP. The amount calculated will be subjected to further reduction if it exceeds 10% of capital and surplus or it exceeds the amount of gross deferred tax liabilities. CUP had net admitted deferred tax assets of $209,167 and $157,020 as of December 31, 2009 and 2008, respectively.

(k) Capital and Surplus

In accordance with the Revised Code of Washington State, CUP is required to maintain a minimum statutory net worth of the greater of $3,000,000 or 2% of premium revenue.

Washington, CUP's state of domicile, imposes minimum risk-based capital requirements that were developed by the NAIC. The formulas for determining the amount of risk-based capital specify various weighting factors that are applied to financial balances or various levels of activity based on the perceived degree of risk. Regulatory compliance is determined by a ratio of CUP's regulatory total adjusted capital, as defined by the NAIC, to its authorized control level risk-based capital, also as defined by the NAIC. Companies below specific trigger points or ratios are classified within certain levels, each of which requires specified corrective action. Management believes CUP is in compliance with its capital and surplus requirements.

CUP must obtain approval from the State of Washington Office of the Insurance Commissioner prior to the payment of any dividends to its shareholders.

(Continued)

(l) ***Recently Adopted Accounting Standards***

In November 2009, the NAIC adopted SSAP 10R, *Income Taxes – Revised, A Temporary Replacement of SSAP 10*. SSAP 10R revises the disclosure requirements related to current and deferred income taxes and allows certain additional deferred tax assets to be admitted for statutory reporting purposes at insurance entities that meet certain risk-based capital requirements. Additionally, it requires reduction of deferred tax assets by a valuation allowance if it is more likely than not that they will not be realized. CUP adopted SSAP 10R for the year ended December 31, 2009. The adoption resulted in the additional disclosures included in note 9 to the statutory financial statements.

(3) Investments

The cost or amortized cost, gross unrealized gains and losses, and estimated fair value of investments held are as follows:

	December 31, 2009			
	Cost or amortized cost	Gross unrealized gains	Gross unrealized losses	Estimated fair value
Bonds:				
U.S. government-sponsored agencies	$ 5,673,171	26,646	(2,719)	5,697,098
States, territories, and possessions	351,784	4,729	—	356,513
Political subdivision of states, territories, and possessions	2,917,429	37,491	(1,032)	2,953,888
Unaffiliated industrial and miscellaneous	170,691	—	(278)	170,413
Total bonds	9,113,075	68,866	(4,029)	9,177,912
Common stock – mutual funds	225,150	83,904	—	309,054
Total	$ 9,338,225	152,770	(4,029)	9,486,966

	December 31, 2008			
	Cost or amortized cost	Gross unrealized gains	Gross unrealized losses	Estimated fair value
Bonds:				
U.S. government-sponsored agencies	$ 6,535,293	92,323	—	6,627,616
Political subdivision of states, territories, and possessions	2,429,477	8,464	(2,727)	2,435,214
Total bonds	8,964,770	100,787	(2,727)	9,062,830
Common stock – mutual funds	225,150	—	—	225,150
Total	$ 9,189,920	100,787	(2,727)	9,287,980

The cost or amortized cost and estimated fair value of fixed income investments at December 31, 2009 by contractual maturity are shown below. Expected maturities may differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without prepayment obligations.

	2009	
	Cost or amortized cost	Estimated fair value
Due in less than one year	$ 2,616,731	2,638,347
Due after one year through five years	6,496,344	6,539,565
Total	$ 9,113,075	9,177,912

Proceeds from maturity of investments in bonds and common stock during 2009 and 2008 were $7,210,000 and $5,503,872, respectively. Gross gains of $0 and $4,703 were realized on those maturities in 2009 and 2008, respectively. No gains and losses were realized on sales of common stock.

Net investment income, including amortization and accretion, is summarized as follows:

	2009	2008
Interest income – bonds	$ 231,192	346,257
Interest and dividend income – short-term investments	30,483	204,316
Interest expense	(12,753)	(9,515)
Interest and dividend income – common stock	2,189	25,821
Other than temporary impairment – common stock	—	(175,000)
Realized gains – common stock	—	4,703
	$ 251,111	396,582

COLUMBIA UNITED PROVIDERS, INC.

Notes to Statutory Financial Statements

December 31, 2009 and 2008

The following table summarizes the investments with unrealized losses as of December 31, 2009:

		Less than 12 months		12 months or longer		Total	
		Estimated fair value	Unrealized losses	Estimated fair value	Unrealized losses	Estimated fair value	Unrealized losses
Bonds:							
U.S. government-sponsored agencies	$	—	—	1,097,906	2,719	1,097,906	2,719
Political subdivision of states, territories, and possessions		—	—	645,724	1,032	645,724	1,032
Unaffiliated Industrial and Miscellaneous		170,413	278	—	—	170,413	278
Temporarily impaired securities	$	170,413	278	1,743,630	3,751	1,914,043	4,029

The following table summarizes the investments with unrealized losses as of December 31, 2008:

		Less than 12 months		12 months or longer		Total	
		Estimated fair value	Unrealized losses	Estimated fair value	Unrealized losses	Estimated fair value	Unrealized losses
Bonds:							
Political subdivision of states, territories, and possessions	$	500,000	15	1,158,517	2,712	1,658,517	2,727
Temporarily impaired securities	$	500,000	15	1,158,517	2,712	1,658,517	2,727

These temporarily impaired securities are the result of market value and interest rate changes and are expected to regain their lost value with market shifts. Management has the intent to hold these investments until their lost value is regained and does not believe them to be other-than-temporarily impaired at December 31, 2009 or 2008.

Any decline in the market value of any investment below carrying value that is deemed to be other than temporary results in a reduction in the carrying value to fair value. The impairment is charged to earnings, and a new basis for the investment is established. In determining whether the losses are temporary or other than temporary, CUP considers: (1) the length of time and extent to which the fair value has been less than cost or carrying value, (2) the financial strength of the issuer, (3) its intent and ability to retain the security for a period of time sufficient to allow for anticipated recovery, which may be to investment maturity, and (4) its expectation of ability to collect all contractual or estimated cash flows. Based on this evaluation, no other-than-temporary impairment losses were recognized in 2009. In 2008, CUP recognized other-than-temporary impairment losses of $175,000 on investments in equity securities. The unrealized losses were caused by general declines in the stock market for which recovery was not expected within a reasonable period of time. Other-than-temporary impairment losses are included in "net investment income" on the statements of revenue and expenses and changes in surplus – statutory basis.

(Continued)

(4) Reserve for Claims Unpaid and Unpaid Claims Adjustment Expense

Claims unpaid include both reported and unreported medical claims. Unreported medical claims represent an actuarial estimate of claims incurred on behalf of CUP's members that had not yet been reported to CUP at December 31 based on a number of factors, including prior claims experience; adjustments, if necessary, are made to hospital and medical expenses in the periods the actual claims costs are ultimately determined.

Claims adjustment expense represents costs incurred related to the claim settlement process such as costs to record, process, and adjust claims. These expenses are calculated using a percentage of current medical costs, based on historical experience.

The following table summarizes activities in the reserve for claims unpaid and claims adjustment expense for the years ended December 31:

	2009	2008
Claims unpaid at beginning of year	$ 7,111,014	7,391,505
Add incurred claims related to:		
Current year	88,097,829	75,781,468
Prior years	(2,813,593)	(1,337,303)
Total incurred	85,284,236	74,444,165
Deduct paid claims related to:		
Current year	81,292,715	68,840,459
Prior years	4,297,421	5,884,197
Total paid	85,590,136	74,724,656
Claims unpaid at end of year	$ 6,805,114	7,111,014

Reserves for claims unpaid and claims adjustment expense attributable to insured events of prior years decreased $2,813,593 and $1,337,303 in 2009 and 2008, respectively, as a result of reestimation of claims unpaid and claim adjustment expense. This decrease is generally the result of ongoing analysis of recent loss development trends. Original estimates are increased or decreased as additional information becomes known regarding individual claims.

(5) Related-Party Transactions

(a) *Southwest Washington Medical Center (SWMC)*

A significant portion of hospital healthcare services provided to CUP enrollees are provided by SWMC. SWMC is controlled by SWHS. Fee-for-service reimbursement paid to SWMC was $17,009,589 and $16,795,183 in 2009 and 2008, respectively. Additionally, SWMC received $1,000,000 in risk share reimbursement from CUP in 2009. Certain professional medical services are provided to CUP enrollees by clinics owned by SWMC or its parent. CUP reimburses these clinics through capitation and fee-for-service arrangements. Total amounts paid to these clinics were $4,064,495 and $4,354,625 in 2009 and 2008, respectively.

(Continued)

CUP performs certain medical management and claims payment functions for Family Physicians Group P.S., a clinic owned by SWHS. Total fees received in 2009 and 2008 related to this agreement were $128,235 and $141,048, respectively. These fees are recorded as a reduction to general administrative expense.

Beginning January 1, 2009, CUP contracted with SWMC to perform certain medical management services for is self-insured employee health plan. Total fees received in 2009 for these services were $190,534. These fees are recorded as a deduction to general administrative expense.

Due to the related nature of these entities, the amounts received and paid may not have been the same if similar activities had been undertaken with unrelated parties.

(b) Physicians

CUP contracts with physicians and other healthcare professionals to provide care for its enrollees. These contracts are negotiated on a year-to-year basis and include capitation and fee-for-service arrangements. Some of these providers may be minority owners of CUP common stock and may be members of CUP's board of directors. Management believes that the loss of certain members of its provider network would have a significant detrimental effect on its ability to provide healthcare services to its enrollees.

CUP performs certain medical management and claims payment functions for a clinic, which is owned by minority shareholders of CUP, and which is represented on CUP's board of directors. Total fees received in 2009 and 2008 related to this agreement were $254,921 and $207,857, respectively. These fees are recorded as a reduction to general administrative expense.

(6) Commitments

Pursuant to Title 48 of the Revised Code of Washington, the Washington State Health Insurance Pool (WSHIP) may assess state health plans to cover the net cost of insuring eligible Washington residents who are denied health coverage elsewhere. Plans are assessed annually based on a per-member per-month basis. CUP's WSHIP assessments for 2009 and 2008 are $663,816 and $536,800, respectively, and are included in general administrative expense in the year of assessment.

CUP has contracted with a healthcare information systems vendor to provide software licensing, data processing, and support to CUP for its claims and managed care administration. This agreement terminates in November 2010. CUP pays a monthly fee based on the number of CUP users. Total data processing support expense for 2009 and 2008 was $276,743 and $256,739, respectively.

In January 2002, CUP executed a noncancelable operating lease for office space. The commencement date of the lease was January 1, 2002. The term is 10 years, with two 5-year renewal options. The lease agreement calls for escalating rent payments over the life of the lease, which CUP records in its statutory statements of revenues and expenses on a straight-line basis. In addition, CUP pays a pro rata share of building operation and maintenance costs. CUP recorded lease expense related to the office space of $457,800 and $456,424 for the years ended December 31, 2009 and 2008, respectively.

The following is a schedule of future minimum payments required under CUP's operating lease and the software licensing and data processing arrangement at December 31, 2009:

2010	$	658,703
2011		449,703
Total future minimum payments	$	1,108,406

(7) Retirement Plan

CUP maintains a 401(k) plan covering substantially all employees. Matching contributions of up to 4% of an employee's compensation are made by CUP in addition to a profit sharing contribution, as established by CUP. CUP contributed $178,358 and $158,165 for 2009 and 2008, respectively.

(8) Uninsured Plans

CUP performs certain administrative functions for uninsured plans of related entities (see note 5(a)). Net reimbursement received for administrative services only (ASO) plans was $128,235 and $141,048 in 2009 and 2008, respectively. The net reimbursement approximates the cost of providing such services and is included in general and administrative expense. The claims paid volume for 2009 and 2008 was approximately $1,187,690 and $1,478,409, respectively.

CUP performs certain administrative functions for a self-funded employee health plan of related entities (see note 5(a)). Net reimbursement for administrative services only (ASO) was $190,534. The reimbursement from this ASO plan resulted in a net gain of $60,492 in 2009. Such reimbursement is included as an offset to general and administrative expense.

CUP performs certain administrative functions for the uninsured plan of a related entity (see note 5(b)). Gross reimbursement for medical cost incurred under this administrative services contract for 2009 and 2008 was $3,618,248 and $2,944,154, respectively. Net reimbursement for administrative services provided by CUP was $254,921 and $207,857 for 2009 and 2008, respectively, which approximates the cost of providing such services. Such reimbursement is included as an offset to general and administrative expense.

(Continued)

(9) Income Taxes

The Company adopted SSAP 10R effective December 31, 2009. The December 31, 2009 balances and related disclosures are calculated and presented pursuant to SSAP 10R. The December 31, 2008 balances and related disclosures are calculated and presented pursuant to SSAP 10R prior to its modification by SSAP 10R. The Company has not elected to admit additional deferred tax assets pursuant to paragraph 10.e. for the year ended December 31, 2009.

	December 31, 2009			December 31, 2008	
	Ordinary	Capital	Total	Total	Change
Total gross deferred tax assets	$ 238,937	59,500	298,437	276,604	21,833
Valuation allowance adjustment	—	—	—	— (a)	—
Adjusted gross deferred tax assets	238,937	59,500	298,437	276,604	21,833
Total gross deferred tax liabilities	—	(28,527)	(28,527)	—	(28,527)
Net deferred tax assets/(liabilities)	238,937	30,973	269,910	276,604	(6,694)
Total deferred tax assets nonadmitted	(29,770)	(30,973)	(60,743)	(119,584)	58,841
Net admitted deferred tax assets/(liabilities)	$ 209,167	—	209,167	157,020	52,147

(a) Statutory valuation allowance was implemented as part of SSAP 10R effective as of December 31, 2009.

The change in deferred income taxes reported in surplus before consideration of nonadmitted assets is comprised of the following components:

	December 31, 2009	December 31, 2008	Change
Net adjusted deferred tax asset (liability)	$ 269,910	276,604	(6,694)
Tax-effect of unrealized gains and losses	28,527	—	28,527
Net tax effect without unrealized gains and losses	$ 298,437	276,604	$ 21,833

Unrecognized Deferred Tax Liabilities

There are no temporary differences for which deferred tax liabilities are not recognized.

Current income taxes incurred consists of the following significant components:

		December 31, 2009	December 31, 2008
Current year tax expense (benefit) exclusive of items listed below	$	1,432,440	1,007,357
Prior year adjustments		(15,629)	—
Income taxes incurred	$	1,416,811	1,007,357

The Company's income tax incurred and change in deferred income tax differs from the amount obtained by applying the federal statutory rate of 34% to income before income taxes as follows:

		December 31, 2009	December 31, 2008
Current income taxes incurred	$	1,416,811	1,007,357
Change in deferred income tax (without tax on unrealized gains and losses)		(21,833)	661,396
Total income tax reported	$	1,394,978	1,668,753
Income before taxes	$	4,401,301	4,866,683
		34%	34%
Expected income tax expense (benefit) at 34% statutory rate	$	1,496,442	1,654,673
Increase (decrease) in actual tax reported resulting from:			
Nondeductible expenses for meals, penalties, and lobbying		2,788	3,679
Tax-exempt income		(19,993)	—
Change in deferred taxes on non-admitted assets		(21,908)	4,678
Other		(62,351)	5,723
Total income tax reported	$	1,394,978	1,668,753

Operating Loss Carryforward

As of December 31, 2009, there are no operating loss or tax credit carryforwards available for tax purposes. The amount of federal income taxes incurred that are available for recoupment in the event of future net losses are:

		Ordinary	Capital	Total
2009	$	1,348,179	—	1,348,179
2008	$	923,407	3,312	926,719

The aggregate amount of deposits admitted under Section 6603 of the Internal Revenue Code are $0.

(Continued)

Deferred income tax assets and liabilities consist of the following major components:

	December 31, 2009			December 31, 2008	Change
	Ordinary	Capital	Total		
Deferred tax assets:					
Deferred rent	$ 25,324	—	25,324	38,581	(13,257)
Claims expense	44,793	—	44,793	49,036	(4,243)
Vacation accrual	57,800	—	57,800	49,000	8,800
Other-than-temporary impairment	—	59,500	59,500	61,250	(1,750)
Fixed assets	22,481	—	22,481	38,147	(15,666)
Other	88,539	—	88,539	40,590	47,949
Total gross deferred tax assets	238,937	59,500	298,437	276,604	21,833
Valuation allowance adjustment	—	—	—	—	—
Total adjusted gross deferred tax assets	238,937	59,500	298,437	276,604	21,833
Nonadmitted deferred tax assets	(29,770)	(30,973)	(60,743)	(119,584)	58,841
Admitted deferred tax assets	209,167	28,527	237,694	157,020	80,674
Deferred tax liabilities:					
Unrealized (gains) losses	—	(28,527)	(28,527)	—	(28,527)
Total deferred tax liabilities	—	(28,527)	(28,527)	—	(28,527)
Net admitted deferred tax asset	$ 209,167	—	209,167	157,020	52,147

(10) Fair Value of Financial Instruments

The carrying amount reported in the statutory statements of admitted assets, liabilities, capital and surplus for uncollected premiums, amounts receivable from uninsured health plans, net deferred tax assets, interest and other investment income due and accrued, healthcare receivables, receivables from reinsurers, receivables from affiliate, claims unpaid, unpaid claims adjustment expense, federal income tax payable, and other expenses due or accrued approximate fair value because of the short maturity of these instruments.

In September 2006, the FASB issued SFAS No. 157 (SFAS 157), *Fair Value Measurement*, which defines fair value and establishes a framework for measuring fair value and expands disclosures about fair value measurements. In accordance with SFAS 157, financial assets and financial liabilities measured at fair value are grouped in three levels, based on the markets in which the assets and liabilities are traded and the reliability of the assumptions used to determine fair value. These levels are:

- Level 1 – Valuations for assets and liabilities traded in active exchange markets, such as the New York Stock Exchange. Valuations are obtained from readily available pricing sources for market transactions involving identical assets or liabilities. Level 1 includes CUP's mutual funds.
- Level 2 – Valuations for assets and liabilities traded in less active dealer or broker markets. Level 2 valuations are based upon quoted prices for similar instruments in active markets, quoted prices for identical or similar instruments in markets that are not active, and model-based valuation techniques for which all significant assumptions are observable in the market. CUP has no Level 2 financial assets or financial liabilities that are measured at fair value in the statutory statements of admitted assets, liabilities, and capital and surplus.
- Level 3 – Valuations for assets and liabilities that are derived from other valuation methodologies, including discounted cash flow models and similar techniques, and not based on market exchange, dealer, or broker-traded transactions. Level 3 valuations incorporate certain assumptions and projections in determining the fair value assigned to such assets or liabilities. CUP has no Level 3 financial assets or financial liabilities.

The following table presents the balances of assets and liabilities measured at fair value on a recurring basis at December 31, 2009:

	Fair value	Level 1	Level 2	Level 3
Assets:				
Mutual funds	$ 309,054	309,054	—	—
	$ 309,054	309,054	—	—

The following table presents the balances of assets and liabilities measured at fair value on a recurring basis at December 31, 2008:

	Fair value	Level 1	Level 2	Level 3
Assets:				
Mutual funds	$ 225,150	225,150	—	—
	$ 225,150	225,150	—	—

(11) Reconciliation between the Audited Statutory Financial Statements and the Annual Statement Filed with the State of Washington Office of the Insurance Commissioner

Certain adjustments were made to the December 31, 2009 and 2008 statutory financial statements that were not reflected in CUP's annual filings with State of Washington Office of the Insurance Commissioner. The tables below reflect these adjustments as shown on the current year statutory financial statements and in CUP's annual filings as of and for the years ended December 31, 2009 and 2008, respectively.

		As reported on the annual filing	Reclass-ifications and adjustments	As reported on the statutory financial statements
December 31, 2009:				
Statutory statement of admitted assets, liabilities, capital and surplus:				
Net deferred tax assets	1	$ 183,667	25,500	209,167
Federal income tax refund receivable	1	974,620	70,567	1,045,187
Unassigned surplus	1	11,446,162	96,067	11,542,229
Statutory statement of revenues and expenses:				
Hospital and medical expenses	2	82,467,472	800,000	83,267,472
Net realized capital gains (losses)	3	(189,817)	189,817	—
Federal income tax expense	1, 2, 3	1,754,018	(337,207)	1,416,811
Statutory statement of changes in capital and surplus:				
Net income (loss)	4	3,257,466	(272,976)	2,984,490
Change in net unrealized gains and losses on investments, net of tax	3	273,720	(218,343)	55,377
Change in net deferred tax asset	1	23,539	(1,706)	21,833
Change in nonadmitted assets	1	(158,847)	61,250	(97,597)
Statutory statement of cash flows:				
Benefit and loss-related payments	5	83,051,662	17,000	83,068,662
Commissions, expenses paid, and aggregate write-ins for deductions	5	9,588,186	(17,000)	9,571,186

1 Tax effects of certain year-end adjustments were recorded subsequent to CUP's annual filing

2 Reversing impact of prior year entry to audited financial statements to reduce claims unpaid and related tax effects

3 Reversing impact of prior year entry to audited financial statements to recognize other-than-temporary impairment and reduction of current year other-than-temporary impairment and related tax effects

(Continued)

4 Net income (loss) was adjusted as a result of items 1, 2, and 3 above and the related tax affect.

5 These line items were adjusted due to the above adjustments in 1, 2, and 3; corrections to the presentation of the cash flows in accordance with statutory reporting.

		As reported on the annual filing	Reclass-ifications and adjustments	As reported on the statutory financial statements
December 31, 2008:				
Statutory statement of admitted assets, liabilities, capital and surplus:				
Net deferred tax assets	2	$ 162,537	(5,517)	157,020
Claims unpaid	1	7,737,199	(783,000)	6,954,199
Unpaid claims adjustment expense	1	173,815	(17,000)	156,815
Federal income tax payable	1	462,870	266,641	729,511
Unassigned surplus	1,2	8,068,203	527,842	8,596,045
Statutory statement of revenues and expenses:				
Hospital and medical expenses	1	72,086,010	(800,000)	71,286,010
Net investment income	2	571,582	(175,000)	396,582
Federal income tax expense	1	740,716	266,641	1,007,357
Statutory statement of changes in capital and surplus:				
Net income (loss)	3	3,500,967	358,359	3,859,326
Change in net unrealized gains and losses on investments, net of tax	2	(183,186)	175,000	(8,186)
Change in net deferred tax asset	2	(620,129)	(41,267)	(661,396)
Change in nonadmitted assets	2	816,696	35,750	852,446
Statutory statement of cash flows:				
Benefit and loss related payments	4	(72,024,082)	17,000	(72,007,082)
Commissions, expenses paid and aggregate write-ins for deductions	4	(9,031,829)	(17,000)	(9,048,829)
Investment income, net of investment expenses	4	671,753	(175,000)	496,753
Other (applications) sources	4	(85,505)	175,000	89,495

1 Claims unpaid and unpaid claims adjustment expense were adjusted for a change in estimate due to better-known information.

2 Other-than-temporary impairments were reclassified from statutory surplus to net investment income.

3 Net income (loss) was adjusted as a result of items 1 and 2 above and the related tax affect.

4 These line items were adjusted due to the above adjustments in 1, 2, and 3; corrections to the presentation of the cash flows in accordance with statutory reporting.

COLUMBIA UNITED PROVIDERS, INC.

Notes to Statutory Financial Statements

December 31, 2009 and 2008

(12) Subsequent Events

CUP evaluated subsequent events after the balance sheet date of December 31, 2009 through May 13, 2010, which was the date the financial statements were available to be issued, and determined that no additional disclosures were necessary, except as noted in prior footnotes.

Schedule 1

COLUMBIA UNITED PROVIDERS, INC.

Investment Risks Interrogatories

December 31, 2009

CUP's total admitted assets as reported on page two of the Company's Annual Statement for the year ended December 31, 2009 is: $ 22,464,897

The following are CUP's 10 largest exposures to a single issuer, borrower, and/or investment, excluding U.S. government, U.S. government agency securities, and exempt money market funds, December 31, 2009:

Investment category		Amount	Percentage of admitted assets
Bonds:			
Multnomah County, OR General Obligation Bond	$	503,072	2%
Toole County, UT General Obligation Bond		417,752	2
Douglas County, WA School District		365,223	2
Multnomah County, OR School District		320,629	1
Snohomish County, WA General Obligation Bond		330,638	1
Grand Haven, MI General Obligation Bond		307,063	1
King County, WA School District #411		281,553	1
King County, WA General Obligation Bond		263,089	1
Washington State General Obligation Bond		203,010	1
Mutual funds:			
Growth Fund of America CL A		153,002	1

The following are the amounts and percentages of CUP's total admitted assets held in bonds, government money markets, and preferred stock by NAIC rating:

		Amount	Percentage of total admitted assets
Bonds:			
NAIC – 1	$	9,113,075	41%
NAIC – 2 through NAIC – 6		—	—

At December 31, 2009, $577,786 of CUP's cash balances were pledged as collateral and were, therefore, restricted from sale.

CUP's admitted assets held in equity interests, excluding exempt or class one money market funds, at December 31, 2008, are as follows:

Issuer		Amount	Percentage of admitted assets
Growth Fund of America CL F	$	153,002	1%
Artisan International Funds		68,941	—
Royce Opportunity Funds		39,212	—
TCM Small Cap Growth Funds		31,733	—
Artisan MidCap Funds		7,446	—
Dodge & Cox Stock Funds		5,317	—
Dodge & Cox International Funds		3,403	—

See accompanying independent auditors' report.

Schedule 2

COLUMBIA UNITED PROVIDERS, INC.

Summary Investment Schedule

December 31, 2009

Investment categories	Gross investment holdings* Amount	Gross investment holdings* Percentage	Admitted assets as reported in the annual statement Amount	Admitted assets as reported in the annual statement Percentage
Bonds:				
U.S. government-sponsored agencies	$ 5,673,171	30.4%	$ 5,673,171	30.4%
Other debt securities (excluding short term):				
States, territories, and possessions general obligations	351,784	1.9	351,784	1.9%
Political subdivisions of states, territories, and possessions	2,917,429	15.7	2,917,429	15.7
Industrial development and similar obligations	170,691	0.9	170,691	0.9
Equity interests:				
Investments in mutual funds	309,054	1.7	309,054	1.7
Cash, cash equivalents, and short-term investments	9,215,465	49.4	9,215,465	49.4
Total invested assets	$ 18,637,594	100.0%	$ 18,637,594	100.0%

* Gross investment holdings as valued in compliance with *NAIC Accounting Practices and Procedures Manual*.

See accompanying independent auditors' report.

PEACEHEALTH

CONSOLIDATED FINANCIAL STATEMENTS

FOR YEARS ENDED JUNE 30, 2007 AND 2006

TABLE OF CONTENTS

KPMG

KPMG LLP
Suite 900
801 Second Avenue
Seattle, WA 98104

Independent Auditors' Report

The Board of Directors
of PeaceHealth:

We have audited the accompanying consolidated balance sheets of PeaceHealth (the Corporation) (a Washington not-for-profit corporation) as of June 30, 2007 and 2006, and the related consolidated statements of operations, changes in net assets, and cash flows for the years then ended. These consolidated financial statements are the responsibility of the Corporation's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Corporation's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of PeaceHealth as of June 30, 2007 and 2006, and the results of its operations, changes in net assets, and cash flows for the years then ended in conformity with U.S. generally accepted accounting principles.

KPMG LLP

September 6, 2007

LIABILITIES AND NET ASSETS	2007	2006
Current liabilities:		
Accounts payable	$ 69,827,009	$ 58,385,130
Accrued payroll, payroll taxes and employee benefits	81,798,033	72,523,048
Accrued interest payable	1,500,990	1,616,677
Other current liabilities	20,298,739	27,383,921
Reimbursement settlements payable	9,970,059	20,206,158
Payable under securities lending agreement	46,825,403	60,228,138
Current portion of long-term debt	7,336,206	6,858,458
Total current liabilities	237,556,439	247,201,530
Other liabilities	81,918,869	65,869,950
Long-term debt due after one year	486,508,503	493,687,289
Commitments and contingent liabilities		
Net assets:		
Unrestricted	894,165,306	752,222,275
Temporarily restricted	29,351,317	30,404,281
Permanently restricted	2,592,604	2,442,438
Total net assets	926,109,227	785,068,994
Total liabilities and net assets	$ 1,732,093,038	$ 1,591,827,763

See accompanying notes to
consolidated financial statements

PEACEHEALTH

CONSOLIDATED STATEMENTS OF OPERATIONS

FOR THE YEARS ENDED JUNE 30, 2007 AND 2006

	2007	2006
Revenues:		
Net patient service revenue	$ 1,089,321,306	$ 998,174,689
Other operating revenue	45,272,198	32,895,792
Total revenues	1,134,593,504	1,031,070,481
Expenses:		
Salaries and wages	504,101,545	451,353,324
Payroll taxes and benefits	119,414,996	105,167,244
Professional fees	4,787,170	4,936,130
Supplies and other expenses	347,504,146	321,038,356
Provision for bad debts	35,097,062	36,371,060
Depreciation and amortization of other assets	56,167,830	52,723,782
Interest and amortization of deferred financing costs	5,444,188	10,395,945
Total expenses	1,072,516,937	981,985,841
Excess of revenues over expenses from operations	62,076,567	49,084,640
Other income:		
Investment income, net	39,277,662	49,545,860
Gain on investments recorded on the equity method	1,186,110	314,400
Loss on refinancing	-	(6,667,691)
Other	271,284	982,531
Total other income, net	40,735,056	44,175,100
Excess of revenues over expenses	102,811,623	93,259,740
Change in net unrealized gains / losses on investments	18,782,169	(1,955,982)
Valuation adjustments on swap arrangements	5,174,515	20,967,000
Net assets released from restrictions used for purchase of property and equipment	10,823,305	2,465,800
Cumulative effect of change in accounting principle	-	(11,537,949)
Other change in unrestricted net assets	4,351,419	-
Increase in unrestricted net assets	$ 141,943,031	$ 103,198,609

See accompanying notes to
consolidated financial statements

PEACEHEALTH

CONSOLIDATED STATEMENTS OF CHANGES IN NET ASSETS

FOR THE YEARS ENDED JUNE 30, 2007 AND 2006

	UNRESTRICTED	TEMPORARILY RESTRICTED	PERMANENTLY RESTRICTED	TOTAL
Net assets at June 30, 2005	$ 649,023,666	$ 24,353,323	$ 2,232,958	$ 675,609,947
Excess of revenues over expenses	93,259,740	-	-	93,259,740
Change in net unrealized gains / losses on investments	(1,955,982)	-	-	(1,955,982)
Valuation adjustments on swap arrangements	20,967,000	-	-	20,967,000
Restricted contributions	-	2,866,658	-	2,866,658
Net assets released from restrictions used for the purchase of property and equipment	2,465,800	(2,465,800)	-	-
Net assets released from restrictions used for operations	-	(359,147)	-	(359,147)
Cumulative effect of change in accounting principle	(11,537,949)	-	-	(11,537,949)
Change in interest in net assets of related foundations	-	6,009,247	209,480	6,218,727
Change in net assets	103,198,609	6,050,958	209,480	109,459,047
Net assets at June 30, 2006	752,222,275	30,404,281	2,442,438	785,068,994
Excess of revenues over expenses	102,811,623	-	-	102,811,623
Change in net unrealized gains / losses on investments	18,782,169	-	-	18,782,169
Valuation adjustments on swap arrangements	5,174,515	-	-	5,174,515
Restricted contributions	-	11,042,799	-	11,042,799
Net assets released from restrictions used for the purchase of property and equipment	10,823,305	(10,823,305)	-	-
Net assets released from restrictions used for operations	-	(656,020)	-	(656,020)
Change in interest in net assets of related foundations	1,446,851	(1,201,521)	150,166	395,496
Other change in net assets	2,904,568	585,083	-	3,489,651
Change in net assets	141,943,031	(1,052,964)	150,166	141,040,233
Net assets at June 30, 2007	$ 894,165,306	$ 29,351,317	$ 2,592,604	$ 926,109,227

See accompanying notes to
consolidated financial statements

PEACEHEALTH

CONSOLIDATED STATEMENTS OF CASH FLOWS
FOR THE YEARS ENDED JUNE 30, 2007 AND 2006

	2007	2006
Cash flows from operating activities:		
Change in net assets	$ 141,040,233	$ 109,459,047
Adjustments to reconcile change in net assets to net cash provided by operating activities:		
Depreciation and amortization	57,439,230	53,329,513
Gain on sale of property, plant and equipment	(159,736)	(100,926)
Provision for bad debts	35,097,062	36,371,060
Restricted contributions	(11,042,799)	(2,591,658)
Net unrealized losses (gains) on investments	(18,782,169)	1,955,982
Valuation adjustments on swap arrangements	(5,174,515)	(20,967,000)
Loss on refinancing	-	2,965,591
Equity investment gain	(1,186,110)	(314,400)
Increase in interest in net assets of related foundations	(395,496)	(6,218,727)
Cumulative effect of change in accounting principle	-	11,537,949
Changes in operating assets and liabilities:		
(Increase) decrease in:		
Accounts receivable, net	(42,366,459)	(40,124,779)
Inventory of supplies	(3,165,109)	(3,090,130)
Prepaid expenses and other current assets	(32,330)	(3,122,662)
Increase (decrease) in:		
Accounts payable (net of capital expenditures)	(15,310,965)	7,217,004
Accrued payroll, payroll taxes and employee benefits	9,274,985	(6,103,675)
Accrued interest payable	(115,687)	(125,526)
Other current liabilities	(7,085,182)	6,141,141
Reimbursement settlements payable	(10,236,099)	9,202,026
Other liabilities	15,352,582	(21,747,359)
Net cash provided by operating activities	143,151,436	133,672,471
Cash flows from investing activities		
Purchase of property, plant and equipment	(269,133,121)	(177,227,413)
Proceeds from sale of property, plant and equipment	633,851	838,605
Purchase of investments	(89,563,343)	(362,376,699)
Sale of investments	250,809,901	381,079,420
Decrease (increase) in assets whose use is limited, other	3,299,223	14,743,693
Increase (decrease) in other assets	(6,534,808)	(3,397,127)
Net cash used by investing activities	(110,488,297)	(146,339,521)
Cash flows from financing activities:		
Proceeds from long-term borrowings	192,620	86,000,000
Principal payments on long-term debt	(6,893,658)	(7,848,236)
Proceeds from restricted contributions	11,042,799	2,591,658
Advance repayment of long-term debt	-	(78,655,000)
Increase in deferred financing costs	(40,235)	(1,914,130)
Net cash provided by financing activities	4,301,526	174,292
Net increase (decrease) in cash and cash equivalents	36,964,665	(12,492,758)
Cash and cash equivalents at beginning of year	21,694,485	34,187,243
Cash and cash equivalents at end of year	$ 58,659,150	$ 21,694,485

See accompanying notes to
consolidated financial statements

PEACEHEALTH

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

JUNE 30, 2007 and 2006

1. Organization

PeaceHealth (the Corporation) is a Washington not-for-profit corporation with its corporate office located in Bellevue, Washington, is sponsored by the Sisters of St. Joseph of Peace and is recognized to be a Private Pontifical Juridic Person by the Roman Catholic Church. At June 30, 2007, the following regional healthcare delivery systems and operating divisions were components of the Corporation:

PeaceHealth Oregon Region, Eugene, Oregon
- Sacred Heart Medical Center
- Cottage Grove Hospital
- PeaceHealth Medical Group
- South Lane Medical Group

PeaceHealth Siuslaw Region, Florence, Oregon
- Peace Harbor Hospital
- Health Associates of Peace Harbor

PeaceHealth Lower Columbia Region, Longview, Washington
- St. John Medical Center
- PeaceHealth Medical Group

PeaceHealth Whatcom Region, Bellingham, Washington
- St. Joseph Hospital
- St. Joseph Medical Group

PeaceHealth Alaska Region, Ketchikan, Alaska
- Ketchikan General Hospital and Medical Clinics
- Island View Manor Nursing Home

Oregon Medical Laboratories

These healthcare delivery systems and operating divisions, along with the Corporation's home office, form the obligated group and are not separate legal entities. The assets of any one are available for the satisfaction of debts of the entire Corporation (subject to the limitations of certain contractual commitments).

Health Ventures is a not-for-profit corporation that has entered into joint ventures to provide radiology, oncology and surgery services. The Corporation is the sole member of Health Ventures. Health Ventures is included in the consolidated financial statements but is not part of the obligated group.

The Corporation is a minority partner in both Premier Purchasing Partners (Premier) and American Excess Insurance Exchange (AEIX). The Corporation has invested in Premier with other healthcare providers for the purpose of lowering costs through group purchasing.

The Corporation accounts for its interest in Premier on the cost method. AEIX is owned by a group of healthcare providers and provides them with excess professional liability insurance coverage. The Corporation accounts for its interest in AEIX on the equity method.

As of June 30, 2007 and 2006 the carrying value of Premier and AEIX was approximately $8,346,000 and $7,160,000 respectively and is recorded in investments in joint ventures and other on the consolidated balance sheets.

In fiscal year 2006 the Corporation created a Real Estate Pooled Income Fund pursuant to IRS Code Sec. 642(c)(5). A pooled income fund is a trust to which donors transfer property, contributing an irrevocable remainder interest in such property to or for the use of a qualified charitable organization and retaining an income interest for the life of one or more beneficiaries. The Real Estate Pooled Income Fund uses the proceeds of all contributions to purchase buildings from the Corporation's obligated group, which are leased back to the Corporation's obligated group under a long-term master lease agreement. The assets and liabilities of the Real Estate Pooled Income Fund are included in the consolidated financials statements but is not part of the obligated group.

2. Summary of significant accounting policies

Consolidation - The consolidated financial statements include the accounts of the Corporation and its controlled affiliates. All significant intercompany transactions and balances have been eliminated.

Estimates - The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. The significant estimates in the Corporation's consolidated financial statements include accounts receivable allowances, third party payer settlement liabilities, and liabilities related to self-insurance programs.

Cash and cash equivalents - Cash and cash equivalents consist of petty cash; cash in demand bank accounts and all highly liquid debt instruments purchased with an original maturity of three months or less other than those whose use is limited. The Corporation held cash equivalents of approximately $48,103,000 and $3,701,000 as of June 30, 2007 and 2006.

Short-term investments - Short-term investments consist primarily of U.S. Government and other investment grade securities and are carried at fair value. Investment income or loss (including realized gains and losses, other than temporary unrealized losses, interest and dividends) is included in the excess of revenues over expenses. Unrealized gains and temporary unrealized losses are excluded from the excess of revenues over expenses and are shown as a change in unrestricted net assets.

Inventory of supplies - Inventory is valued on a last in first out basis or a weighted average cost.

Assets whose use is limited - These items consist of trustee held funds, investments in marketable equity and fixed income securities, mutual funds, investments in joint ventures, investments in expansion property and loans to others. Money market funds and all marketable securities have readily determined market values and are therefore carried at fair value. The investments in joint ventures and other are accounted for using the equity or cost method.

Property, plant and equipment - Property, plant and equipment are stated at cost. Improvements and replacements of plant and equipment are capitalized. Maintenance and repairs are expensed as they are incurred. When property, plant and equipment is sold or retired, the cost and the related accumulated depreciation are removed from the accounts, and the resulting gain or loss is recorded.

Medical office buildings and other - These properties consist of medical offices and other rental buildings and land held for future development. These assets, other than land, are depreciated using the straight-line method over periods of 3 to 40 years.

Depreciation - Depreciation on property, plant and equipment is computed using the straight-line method over the following estimated useful lives:

Land improvements	5 - 20 years
Buildings and improvements	5 - 50 years
Fixed equipment	10 - 25 years
Leasehold improvements	Shorter of remaining length of the lease or useful life
Moveable equipment	3 - 15 years

Deferred financing costs - These costs are amortized over the lives of the related debt issues using the effective interest method.

Other assets – Goodwill recorded in connection with the purchase of certain assets is included in other assets. Goodwill is amortized using the straight-line method over its estimated useful life of two to five years. Other assets also includes the cash surrender value of life insurance on various employees in the Corporation and had a carrying value of approximately $25,509,000 and $18,787,000 as of June 30, 2007 and 2006, respectively.

Donations and grants - Unrestricted donations and grants are recorded as other operating revenues. Donor-restricted donations and grants are recorded as additions to the appropriate class of net assets. When capital expenditures are made consistent with the purpose intended by the donor, a transfer is made from temporarily restricted net assets to unrestricted net assets. If restricted amounts are expended for operations, the amounts are recorded as other operating revenues in the accompanying consolidated statements of operations.

Interest in Net Assets of Related Foundations - The Corporation accounts for activities with its related foundations under Statement of Financial Accounting Standards No. 136, "Transfers of Assets to a Not-For-Profit Organization or Charitable Trust That Raises or Holds Contributions for Others" (SFAS 136). SFAS 136 requires the Corporation to recognize its interests in the net assets of its related foundations.

Recently Adopted Accounting Standards - In March 2006, the Financial Accounting Standards Board (FASB) issued Interpretation No. 47 (FIN 47), "Accounting for Conditional Asset Retirement Obligations", an interpretation of FASB Statement No. 143 (SFAS 143). This interpretation clarified that an entity is required to recognize a liability for the fair value of a conditional asset retirement obligation if the fair value of the liability can be reasonably estimated. Uncertainty about the timing and (or) method of settlement of a conditional asset retirement obligation should be factored into the measurement of the liability when sufficient information exists. The types of asset retirement obligations that are covered by FIN 47 are those for which an entity has a legal obligation to perform an asset retirement activity. However, the timing and (or) method of settling the obligation are conditional on a future event that may or may not be within the control of the entity. SFAS 143 requires the fair value of a liability for a legal obligation associated with an asset retirement be recorded in the period in which the obligation is incurred. When the liability is initially recorded, the cost of the asset retirement is capitalized.

The Corporation adopted FIN 47 effective June 30, 2006 and recorded a liability of $13,512,000, which is included in other liabilities in the accompanying consolidated balance sheets, of which $11,538,000 was recorded as a cumulative effect of a change in accounting principle. Since SFAS 143 requires retrospective application to the inception of the liability, the initial asset retirement obligation was calculated using a discount rate of 5.15%, which approximates the Corporation's weighted average cost of capital at June 30, 2006. The cumulative effect of the adoption of FIN 47 reflects the accretion of the liability and the depreciation of the related asset component from the liability inception date through June 30, 2006.

Substantially all the impact of adopting FIN 47, as described above, relates to estimated costs to remove asbestos that is contained within the Corporation's facilities. The depreciation and accretion costs in fiscal 2007 were $845,000.

New Accounting Pronouncements - In September 2006, the FASB issued Statement of Financial Accounting Standards (SFAS) No. 157, *Fair Value Measurement* (SFAS 157). SFAS 157 defines fair value, establishes a framework for the measurement of fair value, and enhances disclosures about fair value measurements. SFAS 157 does not require any new fair value measures. SFAS 157 is effective for fair value measures already required or permitted by other standards for fiscal years after November 15, 2007. The Corporation is required to adopt SFAS 157 beginning in fiscal year 2008. SFAS 157 is required to be applied prospectively, except for certain financial instruments. Any transition adjustment will be recognized as an adjustment to opening net assets in the year of adoption. Management is still evaluating the potential impact of SFAS 157, but does not expect SFAS 157 to have a material impact on the financial position, results of operations, or cash flows of the Corporation.

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities* (SFAS 159). SFAS 159 permits an organization to measure certain financial instruments at fair value that are not currently required to be measured at fair value. The objective of SFAS 159 is to improve financial reporting by providing companies with the opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions. SFAS 159 permits organizations to choose, at specified election dates, to measure certain items at fair value and report unrealized gains and losses on such items in earnings. SFAS 159 is effective for the Corporation in 2008. Management is still evaluating the potential impact of SFAS 159, but does not expect SFAS 159 to have a material impact on the financial position, results of operations, or cash flows of the Corporation.

In July 2006, the FASB issued FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes,* an interpretation of FASB Statement 109 (FIN 48). FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements and prescribes a threshold of more-likely-than-not for recognition of tax benefits of uncertain tax positions taken or expected to be taken in a tax return. FIN 48 also provides related guidance on measurement, derecognition, classification, interest and penalties, and disclosure. The provisions of FIN 48 will be effective for the Corporation in fiscal year 2008, with any cumulative effect of the change in accounting principle recorded as an adjustment to opening net assets. Management is still evaluating the potential impact of FIN 48, but does not expect FIN 48 to have a material impact on the financial position, results of operations, or cash flows of the Corporation.

Net patient service revenues - The Corporation has agreements with third party payers that provide for payments of amounts different from established charges. The Corporation's net patient service revenue came from the following sources:

	2007	2006
Medicare	39.4%	36.9%
Medicaid	8.3%	8.2%
Commercial & Other	47.6%	50.0%
Private Pay	4.7%	4.9%
	100%	100%

The Corporation has estimated payments for services rendered to Medicare and Medicaid patients during the year by applying the payment principles of the applicable governmental agencies and believes that an adequate provision has been made in the accompanying financial statements for final settlement. Estimates of final settlements to Medicare, Medicaid and other third party payers have been reflected as a reimbursement settlement payable in the accompanying consolidated balance sheets. Differences between the net amounts accrued and subsequent settlements are recorded in operations at the time of settlement.

Reimbursement for inpatient services rendered to Medicare recipients has been made principally under a prospective pricing system based on diagnosis-related groups. Most outpatient services provided to Medicare patients are reimbursed based on prospectively determined rates. Services to Medicaid patients are reimbursed based on a combination of prospectively determined rates and cost reimbursement methodology. Continuation of these reimbursement programs at the present level, and on the present basis, is dependent upon future policies of federal and state governmental agencies.

The Corporation has also entered into payment agreements with certain commercial insurance carriers, health maintenance organizations and preferred provider organizations. The basis for payment to the Corporation under these agreements includes prospectively determined rates per unit of service and discounts from established charges. Most arrangements provide for payment or reimbursement to the Corporation at amounts different than established rates. Contractual discounts represent the difference between established rates for services and amounts paid or reimbursed by these third-party payers.

Other operating revenue - Other operating revenue includes revenue from nonpatient care services, clinical space rental revenues and donations to support operating activities.

Federal and State income taxes - The Corporation has received a determination letter from the Internal Revenue Service stating that it is exempt from Federal income tax under Section 501(c)(3) of the Internal Revenue Code except for tax on unrelated business income. It is management's belief that none of its activities have produced material unrelated business income.

Reclassifications - Certain reclassifications have been made to prior year amounts to conform to the current year presentation to more consistently present financial information between years.

3. Investments

Assets Whose Use is Limited

The composition of cash and investments included in assets whose use is limited at June 30, 2007 and 2006, is set forth in the following table. Investments are stated at fair value.

	2007	2006
Designated for capital acquisition:		
Cash and short-term investments	$57,162,224	$218,939,060
Fixed income	107,385,154	114,777,716
Equity securities	131,538,744	125,052,360
	296,086,122	458,769,136
Trustee held funds:		
Cash and short-term investments	31,349,486	22,597,389
Fixed income	20,159,084	18,564,472
Equity securities	34,878,436	28,472,852
	86,387,006	69,634,713
Other investments:		
Cash and short-term investments	1,924,699	1,227,888
	$384,397,827	$529,631,737

Investment earnings on assets whose use is limited are comprised of the following for the years ended June 30, 2007 and 2006.

	2007	2006
Included in investment income, net:		
Interest income	$21,350,086	$24,054,627
Net realized gain on sales of investments	7,456,208	20,309,277
	$28,806,294	$44,363,904
Included in changes in unrestricted net assets:		
Change in net unrealized gains / losses on assets whose use is limited	$18,062,814	$(1,672,842)

Other than temporary impairment

The individual securities owned by the Corporation that have unrealized losses have been deemed to not require an adjustment for other-than-temporary impairment as the unrealized losses have resulted due to changes in interest rates rather than the credit worthiness of the issuer of the securities.

Securities Lending Agreement

The Corporation has entered into a securities lending agreement whereby a portion of investments are loaned to various brokers in return for cash and securities from the broker as collateral for the securities loaned. Pursuant to the agreement, the collateral received is required to be at least 102% of the fair value of the securities loaned, which is determined at the end of each business day. The securities on loan are comprised entirely of fixed income securities.

4. **Charity care**

The Corporation maintains records to identify and monitor the level of charity care it provides. Charges forgone for services and supplies furnished under the charity care policy for the years ended June 30, 2007 and 2006 were approximately $71,817,000 and $57,734,000 respectively.

5. **Accounts receivable**

Accounts receivable at June 30 consisted of the following:

	2007	2006
Patient accounts receivable	$274,998,284	$257,913,745
Less:		
Allowance for doubtful accounts	(37,585,838)	(47,118,466)
Allowance for estimated contractual discounts	(96,389,175)	(74,774,910)
Net patient accounts receivable	141,023,271	136,020,369
Other accounts receivable	3,374,516	1,108,021
Accounts receivable, net	$144,397,787	$137,128,390

6. Long Term Debt

Long-term debt at June 30 consisted of the following:

	2007	2006
Series 1993 Washington Bonds, variable interest rate (3.72% at June 30, 2007), interest payable each April 1, due in annual installments through 2018, maturing April 1, 2018.	$16,300,000	$17,300,000
Series 1994 Washington Bonds, 5.30%, interest payable each March 1 and September 1, due in annual installments through 2009, maturing March 1, 2009.	2,400,000	3,510,000
Series 1994 Oregon Bonds, 5.625%, interest payable each February 1 and August 1, due in annual installments through 2007, maturing August 1, 2007.	2,620,000	5,100,000
Series 1995 Oregon Bonds, variable interest rate (3.85% at June 30, 2007), interest payable each December 1, due in annual installments through 2015, maturing December 1, 2015.	9,405,000	10,185,000
Series 1998 Oregon Bonds, variable interest rate (3.85% at June 30, 2007), interest payable each December 1, due in annual installments through 2028, maturing December 1, 2028.	12,900,000	13,200,000
Series 2001 Washington Bonds, variable interest rate (3.75% on $40 million and 3.75% on $40 million, at June 30, 2007), interest payable each November 15, due in annual installments from 2016 to 2032, maturing November 15, 2032.	80,000,000	80,000,000
Series 2001 Oregon Bonds, 5.00% to 5.25%, interest payable each May 15 and November 15, due in annual installments from 2017 to 2032, maturing November 15, 2032.	70,000,000	70,000,000
Series 2004 Oregon Bonds, Series A ($15,000,000) 3.00% to 5.00%, interest payable each February 1 and August 1, due in annual installments from 2010 to 2014. Series B-F ($193,350,000), variable interest rate (3.40% to 3.75% at June 30, 2007), due in annual installments from 2008 to 2019 and from 2030 to 2034, maturing August 1, 2034.	208,350,000	208,350,000
Series 2005 Washington Bonds, variable interest rate, (3.75% on $42.7 million and 3.75% on $43.3 million at June 30, 2007), interest payable each October in annual installments through 2028.	86,000,000	86,000,000

Other long-term debt	5,869,709	6,900,747
Total long-term debt	493,844,709	500,545,747
Less amounts due within one year	(7,336,206)	(6,858,458)
Total long-term debt due after one year	$486,508,503	$493,687,289

The Series 1993 Washington, 1995 Oregon, 1998 Oregon, 2001 Washington bonds and a portion of the 2004 Oregon bonds have variable interest rates that may bear interest at a daily, weekly, 28 day, monthly, semi-annual, annual or fixed rates. The rate determination mode may be changed upon request of the Corporation. The bonds are subject to optional redemption by PeaceHealth, in whole or in part at 100% of the principal amount plus accrued interest. The Corporation has a standby bond purchase agreement or letter of credit agreement for the 1993, 1995 and 1998 variable rate demand bonds for the amount of the outstanding principal plus accrued interest. The 2001 auction rate bonds do not require a standby bond purchase agreement. The Series 2004 Oregon bonds consist of six series of bonds, five of which are auction rate bonds with a total par amount of $193,350,000 that have fixed payer swaps associated with them with rates ranging from 3.23% to 3.69%, and $15,000,000 of traditional fixed bonds that have coupons which range from 3.00% to 5.00%, which in aggregate were priced to yield 3.30%. The 2005 Washington bonds consist of two series of bonds that have fixed payer swaps associated with them, which pay 3.281%.

In accordance with the requirements of the Bond Trust Indentures at June 30, the following funds were held by trustees:

	2007	2006
Principal, interest and other funds	$4,026,125	$3,093,846
Project funds	-	15,568
Debt service reserve funds	$1,311,861	1,305,527
	$5,337,986	$4,414,941

These trustee-held funds are included in assets whose use is limited in the accompanying consolidated balance sheets.

The Master Trust Indenture, the loan agreements and other contractual documents under which the Corporation's bonds were issued include covenants obligate the Corporation to: maintain net patient service revenues at levels sufficient to achieve specified debt service coverage ratios; meet certain financial tests before additional debt can be incurred; and to meet certain financial tests before there can be any significant disposition of property.

Scheduled aggregate maturities of long-term debt subsequent to June 30, 2007 are as follows:

Year ending June 30	
2008	7,336,206
2009	7,898,112
2010	9,149,850
2011	11,907,363
2012	12,458,626
Thereafter	445,094,552
Total	$493,844,709

Cash paid for interest totaled approximately $19,929,000 and $20,142,000 for the years ended June 30, 2007 and 2006, respectively. Interest totaling approximately $12,517,000 and $2,413,000 was capitalized in connection with construction projects during the years ended June 30, 2007 and 2006, respectively.

7. Accounting for derivative instruments and hedging activities

In accordance with the policy adopted by the Board of Directors, the Corporation may use interest rate swap contracts to manage its net exposure to interest rate changes in attempting to reduce its overall cost of borrowing over time. Interest rate swap contracts generally involve the exchange of fixed and floating interest rate payments without the exchange of underlying principal (the swap of fixed or floating rates are on a "notional" amount). The Corporation accounts for its interest rate hedging transactions in accordance with Statement of Financial Accounting Standards No. 133 (SFAS 133) "Accounting for Derivative Instruments and Hedging Activities". That standard requires that every derivative instrument be recorded on the balance sheet as either an asset or liability measured at its fair market value. The standard requires that changes in the derivative instrument's fair market value be recognized currently in earnings unless specific hedge accounting criteria are met. Accounting for qualifying fair value hedges allows a derivative instrument's gains and losses to offset related results on the hedged item in the statement of operations, to the extent effective, and for qualifying cash flow hedges the change in the value of the swap to be reported as a component of changes in net assets. The Corporation has formally documented, designated and assessed the effectiveness of transactions that receive hedge accounting treatment.

The Corporation has entered into various interest rate management transactions as of June 30, 2007 with a total notional amount of $519,350,000, which included the following: a $40,000,000 basis swap where PeaceHealth receives 81.9% of 30 day LIBOR and pays a 30 day tax-exempt index rate, $193,350,000 of cash flow hedges (fixed payer swaps) which convert variable rates to fixed rates for the 2004 Oregon bonds, $86,000,000 of cash flow hedges (fixed payer swaps) related to the 2005 Washington bonds, $150,000,000 of cash flow hedges (fixed payer swaps) related to the planned bond issue for the same par amount due to close in October 2007, and a $50,000,000 constant maturity swap that exchanges 68% of 30 day LIBOR for 61.38% of 10 year LIBOR.

The Corporation evaluated the fixed payer swaps and determined that they meet the criteria for hedge accounting in the accompanying financial statements. Using the criteria required by SFAS 133, the Corporation determined that $1,550,000 of the $7,305,000 increase in the fair value of the cash flow hedges in fiscal 2007 was due to hedge ineffectiveness and therefore was recorded as a reduction in interest expense on the consolidated statement of operations. In addition, the basis swap and the constant maturity swap do not qualify for hedge accounting under SFAS 133, and therefore the net combined increase in value reduced interest expense by $581,000 in fiscal 2007. The remaining approximately $5,174,000 was accounted for as an increase in unrestricted net assets. In fiscal 2006, the cash flow hedges experienced an increase in fair value of approximately $27,200,000 of which $21,000,000 was accounted for as an increase in unrestricted net assets and $6,200,000 as hedge ineffectiveness, which reduced interest expense.

Neither the basis swap, nor the constant maturity swap, qualify for hedge accounting treatment and their changes in market value and associated cash flows are included as a component of interest expense. In addition to the net increase in value of the combined swaps of $581,000, cash flow from the basis swap of $297,000 reduced interest expense a total of approximately $878,000 in fiscal 2007. The constant maturity swap did not begin exchanging cash flows until fiscal 2008. In 2006 the interest expense reduction associated with the basis swap was $1,662,000, and the constant maturity swap had not yet been executed.

All of the outstanding interest rate swap transactions allow the Corporation to terminate the financial instruments by requiring full settlement of any interest or termination value, upon 10 days notice given on the first business day of each month. The counterparty can terminate the swaps, requiring full settlement of any interest or termination value, only if the Corporation's credit rating falls to BBB- or equivalent rating. A credit annex also exists that requires either party to post collateral in the amount in excess of a $25,000,000 liability to the other if the party that owes money is in the AA credit category.

In measuring the swaps at fair value, the Corporation has recorded an asset of $20,241,000 and $12,936,000 as of June 30, 2007 and 2006, respectively, which has been recorded in other assets in the accompanying consolidated balance sheets.

8. Medicare and Medicaid revenue

Net revenue for services provided to Medicare patients for the years ended June 30, 2007 and 2006 was approximately $434,689,000 and $374,588,000 respectively. Medicaid net patient service revenue for the years ended June 30, 2007 and 2006 was approximately $91,598,000 and $82,796,000 respectively. Laws and regulations governing the Medicare and Medicaid programs are extremely complex and subject to interpretation. As a result, recorded estimates may change by a material amount in the near term. Adjustments from finalization and adjustment of prior years cost reports and other third-party settlements resulted in an increase in net patient service revenues of approximately $6,000,000 and $3,001,000 for the years ended June 30, 2007 and 2006, respectively.

The Medicare cost reports are subject to retroactive adjustment for three years after settlement, unless held open longer for disputed items. The costs reports receive either full or limited scope audits by the fiscal intermediary appointed by Medicare. Settlements for open years will be finalized after review by the appropriate government agencies.

In fiscal year 2007 the Corporation reevaluated its policy on recording reserves and as a result of the policy changes an additional $8,548,000 was recorded as an increase in net patient service revenue.

9. Restricted net assets

Restricted net assets are those whose use by the Corporation has been limited by donor imposed restrictions to a specific time period and/or purpose. Permanently restricted net assets have been restricted by donors to be maintained in perpetuity.

Temporarily and permanently restricted net assets are available for the following purposes at June 30:

	2007	2006
Purchase of property, plant and equipment	$26,893,927	$28,297,851
Indigent care	255,448	255,359
Patient care operating activities	4,500,406	4,093,864
Other	294,140	199,645
	$31,943,921	$32,846,719

During fiscal year 2007 and 2006, net assets were released from donor restrictions by incurring operating expenses satisfying the restricted purposes of approximately $656,000 and $359,000, respectively. Further, approximately $10,823,000 and $2,466,000 of capital expenditures were made during 2007 and 2006, respectively, that met the guidelines stipulated for reimbursement from donated funds.

10. Retirement plan

The Corporation has a defined contribution retirement plan that covers substantially all employees meeting certain age and length of service requirements. Total retirement plan costs charged to operations were approximately $28,412,000 and $26,495,000 for the years ended June 30, 2007 and 2006, respectively and are included in payroll taxes and benefits in the accompanying consolidated statements of operations.

11. Commitments and contingent liabilities

The Corporation leases, for a nominal amount, the buildings and certain equipment for Ketchikan General Hospital from the City of Ketchikan, Alaska under a ten-year lease that expires in 2013.

The Corporation has begun a project to improve its current facilities and construct a replacement facility for a substantial portion of services for Sacred Heart Medical Center, which is part of its Oregon Region. The Corporation has spent approximately $372,508,000 as of June 30, 2007 and expects the entire project to cost over $685,500,000 and extend through fiscal year 2012. The Corporation has entered into construction and other commitments for approximately $142,283,000 as of June 30, 2007 related to this project.

The Corporation has received approval from the State of Oregon, Department of Human Services, Health Services Division for a certificate of need application. This final order grants approval for a 104 bed hospital at the current location known as Sacred Heart Medical Center at University District. The new license will be effective in 2008 upon the opening of the new facility, Sacred Heart Medical Center at RiverBend. The intent of the Organization was to receive approval to license both facilities and maintain inpatient services on two campuses.

Various laws and regulations of federal, state and local governments govern the healthcare industry. These laws and regulations are subject to on-going government review and interpretation, as well as regulatory actions unknown or unasserted at this time. The Corporation is also involved in litigation and regulatory investigations arising in the course of business. After consultation with legal counsel, management estimates that these matters will be resolved without material adverse effect on the Corporation's future financial position or results from operations.

12. Insurance coverages

The Corporation has a self-insurance program for hospital and physician professional and general liability claims under which the Corporation contributes actuarially determined amounts to a trust to fund estimated ultimate losses. In connection with the self-insurance program, the Corporation has accrued estimates for asserted and incurred but not reported claims. The claims liability has been discounted to present value using a discount rate of 6%. Self-insured professional and general liability retention in 2007 and 2006 was $5,000,000 per occurrence and $18,000,000 in aggregate. Individual general and professional liability claims in excess of the above self-insured retention levels are insured through a claims made excess insurance policy (note 1).

The Corporation also self-insures all or a portion of liabilities related to its medical and dental benefit plans, unemployment and workers' compensation claims. Funding levels are determined based on an actuarial study.

Funded amounts for all self-insured plans, $80,996,000 at June 30, 2007 and $65,170,000 at June 30, 2006, are held in trust and are included in assets whose use is limited in the accompanying consolidated balance sheets.

13. Fair value of financial instruments

At June 30, 2007 and 2006, the Corporation's carrying amount and fair value of financial instruments were as follows:

	2007		2006	
	Carrying Value	Fair Value	Carrying Value	Fair Value
Short-Term Investments	$116,231,390	$116,231,390	$111,853,183	$111,853,183
Securities Lending Agreements	46,825,403	46,825,403	60,228,138	60,228,138
Limited Use Investments	384,397,827	384,397,827	529,631,737	529,631,737
Loans Receivable	2,242,252	2,077,323	1,999,941	1,944,277
Long-Term Debt	493,844,709	496,395,753	500,545,747	501,435,477

Cash and Cash Equivalents - The carrying amount approximates fair value because of the short maturity of those instruments.

Investments - The fair value of investments equals quoted market price. If a quoted market price is not available, fair value is estimated using quoted market prices for similar securities.

Loans Receivable - The fair value is estimated by discounting future cash flows using the current rate at which similar loans would be made to borrowers with similar credit ratings and for the same remaining maturities.

Securities Lending Agreements - The carrying amount approximates fair value because of the short maturity of those instruments.

Long-Term Debt - Rates currently available to the Corporation for debt with similar terms and remaining maturities are used to estimate fair value of debt.

Financial Derivatives – The fair value of derivative financial instruments are developed from quoted market prices for similar instruments (note 7).

14. Subsequent Event

In 2002, the Corporation was sued by McKenzie-Willamette Hospital of Springfield, Oregon (now known as Cascade Health Solutions) in the federal district court of Oregon. The claims included violation of federal antitrust and other laws. In 2003, after trial on the money-damages portion of the lawsuit, the jury returned a verdict in favor of the plaintiff on the following three of the seven claims it had alleged: attempted monopolization, price discrimination and tortious interference. The plaintiff elected damages under the federal antitrust attempted monopolization claim, which, after trebling in accordance with the antitrust law, was $16.2 million, plus approximately $1.6 million in attorneys' fees and expenses as ordered by the district court. PeaceHealth appealed the case to the Ninth Circuit Court of Appeals. In September 2007, the Ninth Circuit Court of Appeals vacated the Federal District Court verdict in favor of the plaintiff and its summary judgment decision in favor of PeaceHealth and remanded the matter back to the Federal District Court for further action. Cascade Health Solutions could now seek an en banc review by the 9th Circuit or seek certiorari review by the US Supreme Court, or retry the case at the federal district court level or enter settlement negotiations with PeaceHealth. At the current time, PeaceHealth cannot determine what course Cascade Health Solutions will take nor can it determine the amount of damages that may be alleged in subsequent proceedings.

After the verdict against it had been entered, the Corporation recognized a charge and established a reserve in fiscal 2005, which including interest amounted to $20.5 million at June 30, 2007. In fiscal 2008, as additional facts are gained, the Corporation will reassess the reserve under Statement of Financial Accounting Standards No. 5, *Accounting for Contingencies* (FAS 5).

PEACEHEALTH

Consolidated Financial Statements

June 30, 2008 and 2007

Table of Contents

KPMG

KPMG LLP
Suite 900
801 Second Avenue
Seattle, WA 98104

Independent Auditors' Report

The Board of Directors
of PeaceHealth:

We have audited the accompanying consolidated balance sheets of PeaceHealth (the Corporation) (a Washington not-for-profit corporation) as of June 30, 2008 and 2007, and the related consolidated statements of operations, changes in net assets, and cash flows for the years then ended. These consolidated financial statements are the responsibility of the Corporation's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Corporation's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of PeaceHealth Corporation as of June 30, 2008 and 2007, and the results of its operations, changes in net assets, and cash flows for the years then ended in conformity with U.S. generally accepted accounting principles.

KPMG LLP

September 11, 2008

KPMG LLP, a U.S. limited liability partnership, is the U.S. member firm of KPMG International, a Swiss cooperative.

PEACEHEALTH

Consolidated Balance Sheets

June 30, 2008 and 2007

Assets	2008	2007
Current assets:		
Cash and cash equivalents	$ 47,047,885	58,659,150
Short-term investments (note 3)	121,305,006	116,231,390
Accounts receivable, net (note 5)	151,798,851	144,397,787
Assets under securities lending agreement (note 3)	57,960,791	46,825,403
Inventory of supplies	23,878,282	21,089,838
Prepaid expenses	10,206,364	8,621,603
Assets whose use is limited that are required for current liabilities	27,076,200	26,692,982
Total current assets	439,273,379	422,518,153
Assets whose use is limited by board designation and indenture agreements:		
Cash and investments (note 3)	385,670,446	384,397,827
Investments in joint ventures and other	45,811,632	38,108,003
Total assets whose use is limited	431,482,078	422,505,830
Less current portion	(27,076,200)	(26,692,982)
Net assets whose use is limited	404,405,878	395,812,848
Property, plant and equipment:		
Land and improvements	59,064,117	55,183,536
Buildings and fixed equipment	512,726,929	496,061,074
Moveable equipment	362,118,323	333,100,483
Medical office buildings and other	71,370,166	55,986,562
Construction in progress	635,510,744	415,845,721
Total property, plant, and equipment	1,640,790,279	1,356,177,376
Less accumulated depreciation	(568,897,399)	(514,078,863)
Net property, plant and equipment	1,071,892,880	842,098,513
Deferred financing costs, net (note 6)	6,068,655	12,318,636
Interest in net assets of related foundations	28,300,681	33,587,095
Other assets	9,443,319	25,757,793
Total assets	$ 1,959,384,792	1,732,093,038

(Continued)

PEACEHEALTH

Consolidated Balance Sheets

June 30, 2008 and 2007

Liabilities and Net Assets	2008	2007
Current liabilities:		
Accounts payable	$ 74,905,212	69,827,009
Accrued payroll, payroll taxes, and employee benefits	86,054,680	81,798,033
Accrued interest payable	1,747,038	1,500,990
Other current liabilities	22,679,702	20,298,739
Reimbursement settlements payable	9,285,856	9,970,059
Payable under securities lending agreement (note 3)	57,960,791	46,825,403
Current portion of long-term debt (note 6)	8,402,274	7,336,206
Total current liabilities	261,035,553	237,556,439
Other liabilities	73,324,287	81,918,869
Long-term debt due after one year (note 6)	635,326,160	486,508,503
Commitments and contingent liabilities (note 11)		
Net assets:		
Unrestricted	963,986,963	894,165,306
Temporarily restricted (note 9)	22,613,229	29,351,317
Permanently restricted (note 9)	3,098,600	2,592,604
Total net assets	989,698,792	926,109,227
Total liabilities and net assets	$ 1,959,384,792	1,732,093,038

See accompanying notes to consolidated financial statements.

PEACEHEALTH

Consolidated Statements of Operations

Years ended June 30, 2008 and 2007

	2008	2007
Revenues:		
Net patient service revenue (note 2)	$ 1,170,105,633	1,089,321,306
Other operating revenue	49,608,436	45,272,198
Total revenues	1,219,714,069	1,134,593,504
Expenses:		
Salaries and wages	561,963,640	504,101,545
Payroll taxes and benefits	137,795,600	119,414,996
Professional fees	4,186,680	4,787,170
Supplies and other expenses	351,915,248	347,504,146
Provision for bad debts	46,090,227	35,097,062
Depreciation and amortization of other assets	58,439,204	56,167,830
Interest and amortization of deferred financing costs (note 7)	26,928,348	5,444,188
Total expenses	1,187,318,947	1,072,516,937
Excess of revenues over expenses from operations before reversal of antitrust judgment accrual	32,395,122	62,076,567
Reversal of antitrust judgment accrual (note 14)	16,955,891	—
Excess of revenues over expenses from operations after reversal of antitrust judgment accrual	49,351,013	62,076,567
Other income:		
Investment income, net (note 3)	48,137,084	39,277,662
Gain on investments recorded on the equity method	10,667,037	1,186,110
Write-off of deferred financing costs (note 6)	(11,126,986)	—
Other	7,441,374	271,284
Total other income, net	55,118,509	40,735,056
Excess of revenues over expenses	104,469,522	102,811,623
Change in net unrealized gains/losses on investments (note 3)	—	18,782,169
Valuation adjustments on swap arrangements (note 7)	(2,894,083)	5,174,515
Net assets released from restrictions used for purchase of property and equipment	19,544,799	10,823,305
Reclassification of cumulative hedge effectiveness (note 7)	(12,704,066)	—
Reclassification of investment securities to trading (note 3)	(38,976,117)	—
Other changes in unrestricted net assets	381,602	4,351,419
Increase in unrestricted net assets	$ 69,821,657	141,943,031

See accompanying notes to consolidated financial statements.

PEACEHEALTH

Consolidated Statements of Changes in Net Assets

Years ended June 30, 2008 and 2007

	Unrestricted	Temporarily restricted	Permanently restricted	Total
Net assets at June 30, 2006	$ 752,222,275	30,404,281	2,442,438	785,068,994
Excess of revenues over expenses	102,811,623	—	—	102,811,623
Change in net unrealized gains/losses on investments	18,782,169	—	—	18,782,169
Valuation adjustments on swap arrangements (note 7)	5,174,515	—	—	5,174,515
Restricted contributions (note 9)	—	11,042,799	—	11,042,799
Net assets released from restrictions used for the purchase of property and equipment	10,823,305	(10,823,305)	—	—
Net assets released from restrictions used for operations	—	(656,020)	—	(656,020)
Change in interest in net assets of related foundations	1,446,851	(1,201,521)	150,166	395,496
Other changes in net assets	2,904,568	585,083	—	3,489,651
Change in net assets	141,943,031	(1,052,964)	150,166	141,040,233
Net assets at June 30, 2007	894,165,306	29,351,317	2,592,604	926,109,227
Excess of revenues over expenses	104,469,522	—	—	104,469,522
Valuation adjustments on swap arrangements (note 7)	(2,894,083)	—	—	(2,894,083)
Restricted contributions (note 9)	—	20,901,901	—	20,901,901
Net assets released from restrictions used for the purchase of property and equipment	19,544,799	(19,544,799)	—	—
Net assets released from restrictions used for operations	—	(944,433)	—	(944,433)
Reclassification of cumulative hedge effectiveness (note 7)	(12,704,066)	—	—	(12,704,066)
Change in interest in net assets of related foundations	406,584	(7,125,920)	505,996	(6,213,340)
Reclassification of investment securities to trading (note 3)	(38,976,117)	—	—	(38,976,117)
Other changes in net assets	(24,982)	(24,837)	—	(49,819)
Change in net assets	69,821,657	(6,738,088)	505,996	63,589,565
Net assets at June 30, 2008	$ 963,986,963	22,613,229	3,098,600	989,698,792

See accompanying notes to consolidated financial statements.

PEACEHEALTH

Consolidated Statements of Cash Flows

Years ended June 30, 2008 and 2007

	2008	2007
Cash flows from operating activities:		
Change in net assets	$ 63,589,565	141,040,233
Adjustments to reconcile change in net assets to net cash provided by operating activities:		
Depreciation and amortization	59,679,745	57,439,230
Gain on sale of land held for sale and property, plant, and equipment	(7,282,887)	(159,736)
Provision for bad debts	46,090,227	35,097,062
Restricted contributions	(20,901,901)	(11,042,799)
Net change in unrealized gains/losses on investments	(8,850,204)	(18,782,169)
Valuation adjustments on swap arrangements	33,032,800	(5,174,515)
Write-off of deferred financing costs	11,126,986	—
Equity investment gain	(7,937,460)	(1,186,110)
Increase in interest in net assets of related foundations	5,286,414	(395,496)
Changes in operating assets and liabilities:		
(Increase) decrease in:		
Accounts receivable, net	(53,491,291)	(42,366,459)
Inventory of supplies	(2,788,444)	(3,165,109)
Prepaid expenses and other current assets	(1,584,761)	(32,330)
Other assets	3,722,992	(6,534,808)
Increase (decrease) in:		
Accounts payable (net of capital expenditures)	(25,595,522)	(15,310,965)
Accrued payroll, payroll taxes, and employee benefits	4,256,647	9,274,985
Accrued interest payable	246,048	(115,687)
Other current liabilities	2,380,963	(7,085,182)
Reimbursement settlements payable	(684,203)	(10,236,099)
Other liabilities	(29,919,067)	15,352,582
Net cash provided by operating activities	70,376,647	136,616,628
Cash flows from investing activities:		
Purchase of property, plant, and equipment	(259,599,492)	(269,133,121)
Proceeds from sale of land held for sale and property, plant, and equipment	9,491,046	633,851
Purchase of investments	(78,530,646)	(89,563,343)
Sale of investments	81,034,615	250,809,901
Decrease in assets whose use is limited, other	233,831	3,299,223
Net cash used in investing activities	(247,370,646)	(103,953,489)
Cash flows from financing activities:		
Proceeds from long-term borrowings	1,010,080,150	192,620
Principal payments on long-term debt	(7,348,797)	(6,893,658)
Proceeds from restricted contributions	20,901,901	11,042,799
Advance repayment of long-term debt	(852,847,628)	—
Increase in deferred financing costs	(5,402,892)	(40,235)
Net cash provided by financing activities	165,382,734	4,301,526
Net (decrease) increase in cash and cash equivalents	(11,611,265)	36,964,665
Cash and cash equivalents at beginning of year	58,659,150	21,694,485
Cash and cash equivalents at end of year	$ 47,047,885	58,659,150

See accompanying notes to consolidated financial statements.

PEACEHEALTH

Notes to Consolidated Financial Statements

June 30, 2008 and 2007

(1) Organization

PeaceHealth (the Corporation) is a Washington not-for-profit corporation with its corporate office located in Bellevue, Washington, is sponsored by the Sisters of St. Joseph of Peace, and is recognized to be a Private Pontifical Juridic Person by the Roman Catholic Church. At June 30, 2008, the following regional healthcare delivery systems and operating divisions were components of the Corporation:

PeaceHealth Oregon Region, Eugene, Oregon:
- Sacred Heart Medical Center
- Cottage Grove Hospital
- PeaceHealth Medical Group
- South Lane Medical Group

PeaceHealth Siuslaw Region, Florence, Oregon:
- Peace Harbor Hospital
- Health Associates of Peace Harbor

PeaceHealth Lower Columbia Region, Longview, Washington:
- St. John Medical Center
- PeaceHealth Medical Group

PeaceHealth Whatcom Region, Bellingham, Washington:
- St. Joseph Hospital
- PeaceHealth Medical Group

PeaceHealth Alaska Region, Ketchikan, Alaska:
- Ketchikan General Hospital and Medical Clinics
- Island View Manor Nursing Home

Oregon Medical Laboratories

These healthcare delivery systems and operating divisions, along with the Corporation's home office, form the obligated group and are not separate legal entities. The assets of any one are available for the satisfaction of debts of the entire Corporation (subject to the limitations of certain contractual commitments).

Health Ventures is a not-for-profit corporation that has entered into joint ventures to provide radiology, oncology, and surgery services. The Corporation is the sole member of Health Ventures. Health Ventures is included in the consolidated financial statements but is not part of the obligated group.

The Corporation is a minority investor in both Premier Purchasing Partners (Premier) and American Excess Insurance Exchange (AEIX). The Corporation has invested in Premier with other healthcare providers for the purpose of lowering costs through group purchasing.

The Corporation accounts for its interest in Premier on the cost method. AEIX is owned by a group of healthcare providers and provides them with excess professional liability insurance coverage. The Corporation accounts for its interest in AEIX on the equity investment method of accounting less mandatory withdrawal penalties and an estimated discount to present value.

(Continued)

As of June 30, 2008 and 2007 the carrying value of Premier and AEIX was approximately $16,283,000 and $8,346,000, respectively, and is recorded in investments in joint ventures and other on the consolidated balance sheets.

In fiscal year 2006 the Corporation created a Real Estate Pooled Income Fund pursuant to Internal Revenue Service Code Section 642(c)(5). A pooled income fund is a trust to which donors transfer property, contributing an irrevocable remainder interest in such property to or for the use of a qualified charitable organization and retaining an income interest for the life of one or more beneficiaries. The Real Estate Pooled Income Fund uses the proceeds of all contributions to purchase buildings from the Corporation's obligated group, which are leased back to the Corporation's obligated group under a long-term master lease agreement. The assets and liabilities of the Real Estate Pooled Income Fund are included in the consolidated financials statements but are not part of the obligated group.

(2) Summary of Significant Accounting Policies

(a) *Consolidation*

The consolidated financial statements include the accounts of the Corporation and its controlled affiliates. All significant intercompany transactions and balances have been eliminated.

(b) *Estimates*

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. The significant estimates in the Corporation's consolidated financial statements include accounts receivable allowances, third-party payor settlement liabilities, and liabilities related to self-insurance programs.

(c) *Cash and Cash Equivalents*

Cash and cash equivalents consist of petty cash; cash in demand bank accounts and all highly liquid debt instruments purchased with an original maturity of three months or less other than those whose use is limited. The Corporation held cash and cash equivalents of $47,047,885 and $58,659,150 as of June 30, 2008 and 2007, respectively.

(d) *Short-Term Investments*

Short-term investments consist primarily of U.S. government and other investment grade securities and are carried at fair value. Investment income or loss (including realized gains and losses and interest and dividends) is included in the excess of revenues over expenses. In fiscal year 2007, unrealized gains and temporary unrealized losses were excluded from the investment income and are shown as a change in unrestricted net assets. In fiscal year 2008, the unrealized gains and losses are included in investment income (note 3).

(e) *Inventory of Supplies*

Inventory is valued on a last–in, first-out basis or a weighted average cost.

PEACEHEALTH

Notes to Consolidated Financial Statements

June 30, 2008 and 2007

(f) ***Assets Whose Use is Limited***

These items consist of trustee held funds, investments in marketable equity and fixed income securities, mutual funds, investments in joint ventures and loans to others. Money market funds and all marketable securities have readily determinable market values and are therefore carried at fair value. The investments in joint ventures and other are accounted for using the equity or cost method.

(g) ***Property, Plant, and Equipment***

Property, plant, and equipment are stated at cost. Improvements and replacements of plant and equipment are capitalized. Maintenance and repairs are expensed as they are incurred. When property, plant, and equipment is sold or retired, the cost and the related accumulated depreciation are removed from the accounts, and the resulting gain or loss is recorded.

(h) ***Medical Office Buildings and Other***

These properties consist of medical offices and other rental buildings. These assets, other than land, are depreciated using the straight-line method over periods of 3 to 40 years.

(i) ***Depreciation***

Depreciation on property, plant, and equipment is computed using the straight-line method over the following estimated useful lives:

Land improvements	5 – 20 years
Buildings and improvements	5 – 50 years
Fixed equipment	10 – 25 years
Leasehold improvements	Shorter of remaining length of the lease or useful life
Moveable equipment	3 – 15 years

(j) ***Deferred Financing Costs***

These costs are amortized over the lives of the related debt issues using the effective-interest method.

(k) ***Other Assets***

At June 30, 2008, other assets consist primarily of the value associated with the plan assets of the Corporation's 457(b) postretirement savings plan, in the amount of $7,812,003, which was recognized during fiscal 2008, with a corresponding amount included in other liabilities. At June 30, 2007, other assets consisted primarily of the estimated fair value of the interest rate swaps of $20,453,602, which were in an asset position at June 30, 2007 and are in a liability position as of June 30, 2008 and included in other long-term liabilities in the accompanying consolidated balance sheets. Additionally, fiscal 2008 other income includes $7,441,834 related to a gain on sale of land held for sale that was included in other assets in the consolidated balance sheet as of June 30, 2007.

(l) ***Donations and Grants***

Unrestricted donations and grants are recorded as other operating revenues. Donor-restricted donations and grants are recorded as additions to the appropriate class of net assets. When capital expenditures are made consistent with the purpose intended by the donor, a transfer is made from temporarily restricted net assets to unrestricted net assets. If restricted amounts are expended for operations, the amounts are recorded as other operating revenues in the accompanying consolidated statements of operations.

(m) ***Interest in Net Assets of Related Foundations***

The Corporation accounts for activities with its related foundations under Statement of Financial Accounting Standards No. 136, *Transfers of Assets to a Not-For-Profit Organization or Charitable Trust That Raises or Holds Contributions for Others* (SFAS 136). SFAS 136 requires the Corporation to recognize its interests in the net assets of its related foundations.

(n) ***Net Patient Service Revenues***

The Corporation has agreements with third-party payors that provide for payments of amounts different from established charges. The Corporation's net patient service revenue came from the following sources:

	2008	2007
Medicare	40.3%	39.4%
Medicaid	8.5	8.3
Commercial and other	46.3	47.6
Private pay	4.9	4.7
	100.0%	100.0%

The Corporation has estimated payments for services rendered to Medicare and Medicaid patients during the year by applying the payment principles of the applicable governmental agencies and believes that an adequate provision has been made in the accompanying consolidated financial statements for final settlement. Estimates of final settlements to Medicare, Medicaid, and other third-party payors have been reflected as a reimbursement settlement payable in the accompanying consolidated balance sheets. Differences between the net amounts accrued and subsequent settlements are recorded in operations at the time of settlement.

Reimbursement for inpatient services rendered to Medicare recipients has been made principally under a prospective pricing system based on diagnosis-related groups. Most outpatient services provided to Medicare patients are reimbursed based on prospectively determined rates. Services to Medicaid patients are reimbursed based on a combination of prospectively determined rates and cost reimbursement methodology. Continuation of these reimbursement programs at the present level, and on the present basis, is dependent upon future policies of federal and state governmental agencies. The Corporation has three critical access hospitals that are exempt from both inpatient and outpatient prospective payment systems. Inpatient and outpatient services rendered to Medicare and Medicaid program beneficiaries at critical access hospitals are reimbursed based on costs. Interim

(Continued)

reimbursement to critical access hospitals is based upon tentative rates and retroactive adjustment is made to actual cost during final settlement by either the Medicare fiscal intermediary or the applicable state's Medicaid agency. The medical groups in the Corporation are generally reimbursed on a fee schedule for Medicare and on a cost basis for Medicaid patients.

The Corporation has also entered into payment agreements with certain commercial insurance carriers, health maintenance organizations, and preferred provider organizations. The basis for payment to the Corporation under these agreements includes prospectively determined rates per unit of service and discounts from established charges. Most arrangements provide for payment or reimbursement to the Corporation at amounts different than established rates. Contractual discounts represent the difference between established rates for services and amounts paid or reimbursed by these third-party payors.

(o) ***Other Operating Revenue***

Other operating revenue includes revenue from nonpatient care services, clinical space rental revenues, and donations to support operating activities.

(p) ***Federal and State Income Taxes***

The Corporation has received a determination letter from the Internal Revenue Service stating that it is exempt from federal income tax under Section 501(c)(3) of the Internal Revenue Code except for tax on unrelated business income. It is management's belief that none of its activities have produced material unrelated business income.

(q) ***Recently Adopted Accounting Standards***

The Corporation adopted FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement 109* (FIN 48), on July 1, 2007. FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with FASB Statement No. 109, *Accounting for Income Taxes*. FIN 48 also prescribes a recognition threshold and measurement standard for the financial statement recognition and measurement of an income tax position taken or expected to be taken in a tax return. Only tax positions that meet the more-likely-than-not recognition threshold at the effective date may be recognized or continue to be recognized upon adoption. In addition, FIN 48 provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. The adoption of FIN 48 did not have a significant impact on the consolidated financial statements of the Corporation.

(r) ***New Accounting Pronouncements***

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurement* (SFAS 157). SFAS 157 defines fair value, establishes a framework for the measurement of fair value, and enhances disclosures about fair value measurements. SFAS 157 does not require any new fair value measures. SFAS 157 is effective for fair value measures already required or permitted by other standards for fiscal years beginning after November 15, 2007. The Corporation is required to adopt SFAS 157 beginning in fiscal year 2009. SFAS 157 is required to be applied prospectively, except for certain financial instruments. Any transition adjustment will be recognized as an adjustment to opening net assets in the year of adoption. Management is currently evaluating the potential impact of SFAS 157, but does not expect SFAS 157 to have a material impact on the financial position, results of operations, or cash flows of the Corporation.

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities* (SFAS 159). SFAS 159 permits an organization to measure certain financial instruments at fair value that are not currently required to be measured at fair value. The objective of SFAS 159 is to improve financial reporting by providing companies with the opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions. SFAS 159 permits organizations to choose, at specified election dates, to measure certain items at fair value and report unrealized gains and losses on such items in earnings. SFAS 159 is effective for the Corporation in fiscal year 2009. Management is currently evaluating the potential impact of SFAS 159, but does not expect SFAS 159 to have a material impact on the financial position, results of operations, or cash flows of the Corporation.

(s) ***Reclassifications***

Certain reclassifications have been made to prior year amounts to conform to the current year presentation to more consistently present financial information between years.

(3) Investments

The composition of cash and investments at June 30, 2008 and 2007 is set forth in the following table. Investments are carried at fair value.

	2008	2007
Operating cash:		
Cash and money market	$ 47,047,885	58,659,150
Short-term fixed income	121,305,006	116,231,390
	168,352,891	174,890,540
Designated for capital acquisition:		
Cash and short-term investments	46,445,636	57,162,224
Fixed income	111,316,178	107,385,154
Equity securities	136,134,584	131,538,744
	293,896,398	296,086,122
Trustee-held funds:		
Cash and short-term investments	39,142,666	31,349,486
Fixed income	20,154,495	20,159,084
Equity securities	31,183,562	34,878,436
	90,480,723	86,387,006
Other investments:		
Cash and short-term investments	1,293,325	1,924,699
	$ 554,023,337	559,288,367

(Continued)

The Corporation does hold commodity investments through two limited partnerships, which are not publicly traded, though the underlying assets in the limited partnership do have fair market values, and the limited partnership shares are liquid investments. The total commodity limited partnership market value was $17,541,706 and $13,120,332 at June 30 2008 and 2007.

Investment income is comprised of the following for the years ended June 30, 2008 and 2007.

		2008	2007
Interest income	$	30,325,903	32,076,538
Net realized gain on sales of investments		8,960,977	7,201,124
Change in net unrealized gains/losses on investments		(30,125,913)	—
Reclassification of securities to trading		38,976,117	—
Investment income, net	$	48,137,084	39,277,662
Included in changes in unrestricted net assets:			
Change in net unrealized gains/losses on assets whose use is limited	$	—	18,782,169
Reclassification of securities to trading		(38,976,117)	—

(a) ***Change in Classification of the Investment Portfolio***

As of July 1, 2007, the Corporation elected to designate its investment portfolio as trading, which resulted in all unrealized gains and losses as being recognized currently as nonoperating activity. The effect of the change in classification of investments to trading resulted in $38,976,117 of cumulative unrealized net gains being recognized as nonoperating gains at July 1, 2007 in the consolidated statement of operations.

(b) ***Other-Than-Temporary Impairment***

In fiscal year 2007, when the investment portfolio was designated as available-for-sale, the individual securities owned by the Corporation that had unrealized losses have been deemed to not require an adjustment for other-than-temporary impairment as the unrealized losses have resulted due to changes in interest rates rather than the credit worthiness of the issuer of the securities. This is not applicable for fiscal year 2008, as the Corporation elected to designate its investment portfolio as trading.

(c) ***Securities Lending Agreement***

The Corporation has entered into a securities lending agreement whereby a portion of investments are loaned to various financial institutions in return for cash or other securities as collateral for the securities loaned. Pursuant to the agreement, the collateral received is required to be at least 102% of the fair value of the securities loaned, which is determined at the end of each business day. The securities on loan are comprised entirely of fixed income securities.

PEACEHEALTH

Notes to Consolidated Financial Statements

June 30, 2008 and 2007

(4) Charity Care

The Corporation maintains records to identify and monitor the level of charity care it provides. Charges forgone for services and supplies furnished under the charity care policy for the years ended June 30, 2008 and 2007 were approximately $80,220,000 and $71,817,000, respectively.

(5) Accounts Receivable

Accounts receivable at June 30 consisted of the following:

	2008	2007
Patient accounts receivable	$ 284,249,317	274,998,284
Less:		
Allowance for doubtful accounts	(35,942,018)	(37,585,838)
Allowance for estimated contractual discounts	(98,409,151)	(96,389,175)
Net patient accounts receivable	149,898,148	141,023,271
Other accounts receivable	1,900,703	3,374,516
Accounts receivable, net	$ 151,798,851	144,397,787

(6) Long-Term Debt

Long-term debt at June 30, consisted of the following:

	2008	2007
Series 1993 Washington Bonds, variable interest rate, (7.25% at June 30, 2008) payable each April 1, due in annual installments through 2018, maturing April 1, 2018	$ 15,200,000	16,300,000
Series 1994 Washington Bonds, 5.30%, interest payable each March 1 and September 1, due in annual installments through 2009, maturing March 1, 2009	1,230,000	2,400,000
Series 1994 Oregon Bonds, 5.625%, interest payable each February 1 and August 1, due in annual installments through 2007, maturing August 1, 2007	—	2,620,000
Series 1995 Oregon Bonds, variable interest rate, (2.05% at June 30, 2008) payable each December 1, due in annual installments through 2015, maturing December 1, 2015	8,580,000	9,405,000
Series 1998 Oregon Bonds, variable interest rate, (6.00% at June 30, 2008) payable each December 1, due in annual installments through 2028, maturing December 1, 2028	12,600,000	12,900,000

	2008	2007
Series 2001 Washington Bonds, variable interest rate, payable each November 15, due in annual installments from 2016 to 2032, maturing November 15, 2032. Advance refunded during 2008	$ —	80,000,000
Series 2001 Oregon Bonds, 5.00% to 5.25%, interest payable each May 15 and November 15, due in annual installments from 2017 to 2032, maturing November 15, 2032	70,000,000	70,000,000
Series 2004 Oregon Bonds, Series A, 3.00% to 5.00%, interest payable each February 1 and August 1, due in annual installments from 2010 to 2014. Series B-F totaling $193,350,000 was advance refunded during 2008	15,000,000	208,350,000
Series 2005 Washington Bonds, variable interest rate, principle payable each October in annual installments through 2028. Advance refunded during 2008	—	86,000,000
Series 2008 Washington Bonds, Series A, fixed interest rate of 5% payable on each May 1 and November 1, maturing November 1, 2018	80,650,000	—
Series 2008 Washington Bonds, Series B-D, variable interest rate, (1.55% at June 30, 2008), principle payable each October in annual installments through 2028	86,715,000	—
Series 2008 Oregon Bonds, Series A-D, variable interest rate, (1.55% at June 30, 2008), principle payable each October in annual installments from 2009 to 2020, then from 2031 to 2035 for Series A and B; from 2036 to 2047 for Series C and D	344,670,000	—
Other long-term debt	9,083,434	5,869,709
Total long-term debt	643,728,434	493,844,709
Less amounts due within one year	(8,402,274)	(7,336,206)
Total long-term debt due after one year	$ 635,326,160	486,508,503

At the end of fiscal year 2008, due to uncertainty in the auction rate market, the Corporation advance redeemed $359,350,000 of its auction rate bonds outstanding at June 30, 2007 and $150,000,000 of auction rate bonds issued in 2008, with $431,385,000 of variable rate demand bonds and $80,650,000 of fixed rate bonds. As a result of this redemption of the debt, the remaining unamortized deferred financing costs of $11,126,986 were recognized as a decrease of other income during fiscal year 2008. The variable rate demand bonds are backed by a letter of credit support with a group of banks in the amount of approximately $436,562,000 which will expire in June 2011. The letter of credit is annually extendable for an additional year at the option of the group of banks.

The Series 1993 Washington, 1995 Oregon, 1998 Oregon, 2008 Oregon Bonds and the 2008 Washington Series B-D Bonds have variable interest rates that may bear interest at a daily, weekly, 28-day, monthly, semiannual or annual rates. The rate determination mode may be changed upon request of the Corporation. The bonds are subject to optional redemption by the Corporation, in whole or in part at 100% of the principal amount plus accrued interest. The Corporation has a standby bond purchase agreement or letter–of-credit agreement for the 1993, 1995, 1998 and 2008 variable rate demand bonds for the amount of the outstanding principal plus accrued interest. The Series 2008 Oregon Bonds consist of four series of bonds, with a total par amount of $344,670,000, which have fixed payor swaps with a notional amount of $343,350,000 associated with them with fixed rates ranging from 3.23% to 3.69%. The Series B-D of the 2008 Washington Bonds with a total par amount of $86,715,000 have fixed payor swaps with a notional amount of $86,000,000 associated with them, which pay a fixed rate of 3.281%.

In accordance with the requirements of the Bond Trust Indentures at June 30, the following funds were held by trustees:

	2008	2007
Principal, interest, and other funds	$ 3,380,897	4,026,125
Debt service reserve funds	1,305,510	1,311,861
	$ 4,686,407	5,337,986

These trustee-held funds are included in assets whose use is limited in the accompanying consolidated balance sheets.

The Master Trust Indenture, the loan agreements, and other contractual documents under which the Corporation's bonds were issued include covenants, which, among others, obligate the Corporation to: maintain net patient service revenues at levels sufficient to achieve specified debt service coverage ratios; meet certain financial tests before additional debt can be incurred; and meet certain financial tests before there can be any significant disposition of property. Management believes that the Corporation was in compliance with all covenants in fiscal years 2008 and 2007.

Scheduled aggregate maturities of long-term debt subsequent to June 30, 2008 are as follows:

Year ending June 30:	
2009	$ 8,402,274
2010	9,740,017
2011	12,535,174
2012	13,074,441
2013	13,209,881
Thereafter	586,766,647
Total	$ 643,728,434

Cash paid for interest totaled approximately $28,335,000 and $19,929,000 for the years ended June 30, 2008 and 2007, respectively. Interest totaling approximately $19,607,000 and $12,517,000 was capitalized in connection with construction projects during the years ended June 30, 2008 and 2007, respectively.

(7) Accounting for Derivative Instruments and Hedging Activities

In accordance with the policy adopted by the Board of Directors, the Corporation may use interest rate swap contracts to manage its net exposure to interest rate changes in attempting to reduce its overall cost of borrowing over time. Interest rate swap contracts generally involve the exchange of fixed and floating interest rate payments without the exchange of underlying principal (the swap of fixed or floating rates are on a "notional" amount). The Corporation accounts for its interest rate hedging transactions in accordance with SFAS No. 133 (SFAS 133), *Accounting for Derivative Instruments and Hedging Activities*.

The Corporation had the following interest rate swap contracts outstanding as of June 30, 2008 with a total notional amount of $469,350,000: a $40,000,000 basis swap whereby the Corporation receives 81.9% of 30-day LIBOR and pays a 30-day tax-exempt index rate, $343,350,000 of cash flow hedges (fixed payor swaps) which convert a portion of the 2008 Oregon Bonds to a fixed rate and $86,000,000 cash flow hedges (fixed payor swaps), which convert a portion of the 2008 Washington Bonds to a fixed rate.

During fiscal year 2008, a $50,000,000 constant maturity swap was terminated, which resulted in the Corporation recording a $2,014,240 gain, which offset interest expense.

In fiscal 2008, as a result of the Corporation refunding its auction rate debt with an equal amount of variable rate demand bonds, an event of "deemed termination" occurred with respect to the accounting for the interest rate swap transactions designated to the auction rate debt. Deemed termination requires that all current period and prior period effective hedge amounts recorded in net assets be reclassified as a component of excess of revenue over expenses on the statement of operations. The Corporation recognized, through interest expense, a gain for the cumulative effective portion of these hedges, previously included in net assets, of $12,704,066, and additional expense for the full amount of the change in the fair value of the interest rate swaps from June 30, 2007 through June 26, 2008, the debt refunding date, of $29,025,902 for a net increase to interest expense of $16,321,836.

All of the fixed payor swaps remained in place throughout the process of replacing the auction rate bonds with variable rate demand bonds. The Corporation redesignated the fixed payor swaps to the variable rate demand bonds and evaluated the swaps determining that they meet the criteria for hedge accounting. At June 30, 2008, after being redesignated as cash flow hedges to the new variable rate demand bonds, the amount of hedge effectiveness related to the change in market value from June 26, 2008 to June 30, 2008 was $2,894,083 and has been recorded as a reduction in net assets. There was no amount recorded to interest expense related to ineffectiveness for the four-day period. The Corporation does not anticipate any of the cumulative effective hedge amount of $2,894,083 to be reclassified into earnings in the next 12 months, and the Corporation does not anticipate the discontinuance of the cash flow hedges.

The basis swap does not qualify for hedge accounting under SFAS 133, and therefore, the decrease in value of $1,324,860 during fiscal 2008 was included in interest expense.

The following table summarizes the impact of the interest rate swaps on interest expense included in the statement of operations:

		2008	2007
Interest expense prior to impact of interest rate swaps	$	11,199,262	6,999,598
Ineffective portion of hedges, deemed termination effect		29,025,902	(1,549,821)
Cumulative effect of deemed termination		(12,704,066)	—
Change in value of nonhedge accounting swaps		(1,112,433)	(580,652)
Amortization of deferred financing cost		519,683	575,063
Interest and amortization	$	26,928,348	5,444,188

All of the outstanding interest rate swap transactions allow the Corporation to terminate the financial instruments by requiring full settlement of any interest or termination value, upon 10 days' notice given on the first business day of each month. If the Corporation's credit rating falls to BBB- or equivalent rating, the counterparty can terminate the swaps, requiring full settlement of any interest or termination value. If either party's credit rating fell to AA or below, the party with the liability must post collateral in the amount in excess of a $25,000,000 liability.

In measuring the swaps at fair value, the Corporation has recorded a liability of $13,438,422 and an asset of $647,103 at June 30, 2008; at June 30, 2007, an asset of $20,453,602 and a liability of $212,427 were recorded. All amounts are recorded respectively in other long-term liabilities or other long-term assets in the accompanying consolidated balance sheets.

(8) Medicare and Medicaid Revenue

Net revenue for services provided to Medicare patients for the years ended June 30, 2008 and 2007 was approximately $471,636,000 and $434,689,000, respectively. Medicaid net patient service revenue for the years ended June 30, 2008 and 2007 was approximately $99,850,000 and $91,598,000, respectively. Laws and regulations governing the Medicare and Medicaid programs are extremely complex and subject to interpretation.

As a result, retroactive adjustments are accrued on an estimated basis in the period the related services are rendered and adjusted in future periods as final settlements are determined or new information is learned. Adjustments from finalization and adjustment of prior years cost reports and other third-party settlements resulted in an increase in net patient service revenues of approximately $4,000,000 and $6,000,000 for the years ended June 30, 2008 and 2007, respectively.

The Medicare cost reports are subject to retroactive adjustment for three years after settlement, unless held open longer for disputed items. The cost reports receive either full- or limited-scope audits by the fiscal intermediary appointed by Medicare. Settlements for open years will be finalized after review by the appropriate government agencies.

(9) Restricted Net Assets

Restricted net assets are those whose use by the Corporation has been limited by donor-imposed restrictions to a specific time period and/or purpose. Permanently restricted net assets have been restricted by donors to be maintained in perpetuity.

Temporarily and earnings on permanently restricted net assets are available for the following purposes at June 30:

	2008	2007
Purchase of property, plant, and equipment	$ 20,416,647	26,893,927
Indigent care	240,082	255,448
Patient care operating activities	4,656,643	4,500,406
Other	398,457	294,140
	$ 25,711,829	31,943,921

During fiscal year 2008 and 2007, net assets were released from donor restrictions by incurring operating expenses satisfying the restricted purposes of approximately $944,000 and $656,000, respectively. Further, approximately $19,545,000 and $10,823,000 were released from restriction for capital expenditures made during 2008 and 2007, respectively.

(10) Retirement Plan

The Corporation has a defined contribution retirement plan that covers substantially all employees meeting certain age and length of service requirements. Total retirement plan costs charged to operations were approximately $32,433,000 and $28,412,000 for the years ended June 30, 2008 and 2007, respectively, and are included in payroll taxes and benefits in the accompanying consolidated statements of operations.

(11) Commitments and Contingent Liabilities

The Corporation leases, for a nominal amount, the buildings and certain equipment for Ketchikan General Hospital from the City of Ketchikan, Alaska under a 10-year lease that expires in 2013.

The Corporation is nearing completion of a project to replace a substantial portion of services for Sacred Heart Medical Center, which is part of its Oregon Region. The Corporation has spent approximately $528,700,000 as of June 30, 2008 and expects the entire project to cost over $579,500,000 and extend through the first few months of fiscal year 2009. The outstanding construction commitments are approximately $50,800,000 as of June 30, 2008 related to this project.

The Corporation is renovating the patient tower of St. John Medical Center, which is part of its Lower Columbia Region. The Corporation has spent approximately $30,916,000 as of June 30, 2008 and expects the entire project to cost approximately $46,000,000 and extend through fiscal year 2010. The Corporation has entered into construction and other commitments for approximately $15,084,000 as of June 30, 2008 related to this project.

Various laws and regulations of federal, state, and local governments govern the healthcare industry. These laws and regulations are subject to ongoing government review and interpretation, as well as regulatory actions unknown or unasserted at this time. The Corporation is also involved in litigation and regulatory investigations arising in the normal course of business. After consultation with legal counsel, management estimates that these matters will be resolved without material adverse effect on the Corporation's future financial position or results of operations.

(12) Insurance Coverages

The Corporation has a self-insurance program for hospital and physician professional and general liability claims under which the Corporation contributes actuarially determined amounts to a trust to fund estimated ultimate losses. In connection with the self-insurance program, the Corporation has accrued estimates for asserted and incurred but not reported claims, including both the expected liability under each claim and the cost to administer the claim. The claims liability has been discounted to present value using a discount rate of 4%. Self-insured professional and general liability retention in 2008 and 2007 was $5,000,000 per occurrence and $18,000,000 in aggregate. Individual general and professional liability claims in excess of the above self-insured retention levels are insured through a claims-made excess insurance policy.

The Corporation also self-insures all or a portion of liabilities related to its medical and dental benefit plans, unemployment, and workers' compensation claims. Funding levels and liabilities are determined based on an actuarial study. Based on the actuarial studies, the Corporation has recorded a liability for all of the self-insurance programs in the amount of $57,307,739 and $64,611,488 at June 30, 2008 and 2007, respectively. The liabilities are classified within other current liabilities and other liabilities based on the historical amounts paid within one year. Total current amounts were $22,082,490 and $19,681,265 at June 30, 2008 and 2007, respectively.

Funded amounts for all self-insured plans, $85,738,885 at June 30, 2008 and $80,996,353 at June 30, 2007, are held in trust and are included in assets whose use is limited in the accompanying consolidated balance sheets.

(13) Fair Value of Financial Instruments

At June 30, 2008 and 2007, the Corporation's carrying amount and fair value of financial instruments were as follows:

	2008		2007	
	Carrying value	Fair value	Carrying value	Fair value
Short-term investments	$ 121,305,006	121,305,006	116,231,390	116,231,390
Securities lending agreements	57,960,791	57,960,791	46,825,403	46,825,403
Limited use investments	385,670,446	385,670,446	384,397,827	384,397,827
Long-term debt	643,728,434	642,744,743	493,844,709	496,395,753

(Continued)

(a) *Cash and Cash Equivalents*

The carrying amount approximates fair value because of the short maturity of those instruments.

(b) *Investments*

The fair value of investments equals quoted market price. If a quoted market price is not available, fair value is estimated using quoted market prices for similar securities.

(c) *Securities Lending Agreements*

The carrying amount approximates fair value because of the short maturity of those instruments.

(d) *Long-Term Debt*

Rates currently available to the Corporation for debt with similar terms and remaining maturities are used to estimate fair value of debt.

(e) *Financial Derivatives*

The fair value of derivative financial instruments are developed from quoted market prices for similar instruments (see note 7).

(14) Subsequent Event

In fiscal year 2002, the Corporation was sued by McKenzie-Willamette Hospital of Springfield, Oregon (now known as Willamette Community Health Solutions, formerly known as McKenzie-Willamette Hospital, an Oregon nonprofit corporation, doing business as Cascade Heath Solutions) in the federal district court of Oregon for claims of a violation of certain federal antitrust and other laws. After an adverse verdict, the Corporation accrued the jury award and attorney fees, including interest through June 30, 2007. During fiscal year 2008, management entered into discussions with Cascade Health Solutions and ultimately resulted in a settlement amount during August 2008. As a result, the Corporation recorded the reversal of the antitrust judgment accrual in the amount of approximately $16,956,000, which is included in the accompanying consolidated statements of operations.

Attachment 4

PEACEHEALTH

CONSOLIDATED FINANCIAL STATEMENTS

FOR YEARS ENDED JUNE 30, 2005 AND 2004

TABLE OF CONTENTS

KPMG

KPMG LLP
Suite 900
801 Second Avenue
Seattle, WA 98104

Independent Auditors' Report

To the Board of Directors
of PeaceHealth:

We have audited the accompanying consolidated balance sheets of PeaceHealth (the Corporation) (a Washington not-for-profit corporation) as of June 30, 2005 and 2004, and the related consolidated statements of operations, changes in net assets, and cash flows for the years then ended. These consolidated financial statements are the responsibility of the Corporation's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Corporation's internal control over financial reporting. Accordingly, we express no such opinion. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of PeaceHealth as of June 30, 2005 and 2004, and the results of its operations, changes in net assets and cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

KPMG LLP

September 2, 2005

KPMG LLP, a U.S. limited liability partnership, is the U.S.
member firm of KPMG International, a Swiss cooperative.

PEACEHEALTH

CONSOLIDATED BALANCE SHEETS

AS OF JUNE 30, 2005 AND 2004

ASSETS	2005	2004
Current assets:		
Cash and cash equivalents	$ 34,187,243	$ 15,579,695
Short-term investments	76,414,366	48,462,281
Accounts receivable, net (Note 5)	133,374,671	122,046,613
Assets under securities lending agreement (Note 3)	109,427,291	79,827,514
Inventory of supplies	14,834,599	13,971,188
Prepaid expenses and other current assets	5,466,611	5,366,882
Assets whose use is limited that are required for current liabilities	6,408,223	3,761,970
Total current assets	380,113,004	289,016,143
Assets whose use is limited by board designation and indenture agreement (Notes 6 and 13):		
Cash and investments (Note 3)	585,729,257	418,030,213
Investments in joint ventures and other	14,112,579	15,100,747
Total assets whose use is limited	599,841,836	433,130,960
Less current portion	(6,408,223)	(3,761,970)
Net assets whose use is limited	593,433,613	429,368,990
Property, plant and equipment:		
Land and improvements	68,020,585	66,456,666
Buildings and fixed equipment	430,009,180	406,780,971
Moveable equipment	333,532,849	339,451,884
Medical office buildings and other	51,483,116	51,002,352
Construction in progress	64,093,078	40,616,063
Total property, plant and equipment	947,138,808	904,307,936
Less accumulated depreciation	(470,354,559)	(458,767,718)
Net property, plant and equipment	476,784,249	445,540,218
Deferred financing costs, net	14,510,656	11,472,571
Interest in net assets of related foundations (Note 2)	26,810,088	22,773,563
Other assets	16,859,273	23,146,181
Total assets	$ 1,508,510,883	$ 1,221,317,666

See accompanying notes to
consolidated financial statements

LIABILITIES AND NET ASSETS	2005	2004
Current liabilities:		
Accounts payable	$ 35,703,417	$ 33,071,052
Accrued payroll, payroll taxes and employee benefits	78,626,723	63,865,590
Accrued interest payable	1,742,203	2,524,863
Other current liabilities	1,074,641	697,049
Reimbursement settlements payable	11,004,132	14,467,832
Payable under securities lending agreement (Note 3)	109,427,291	79,827,514
Current portion of long-term debt (Note 6)	7,845,056	7,952,265
Total current liabilities	245,423,463	202,406,165
Other liabilities (Note 11 and 12)	94,273,546	49,758,835
Long-term debt due after one year (Note 6)	493,203,927	338,963,032
Commitments and contingent liabilities (Note 12)		
Net assets:		
Unrestricted	649,023,666	608,058,075
Temporarily restricted (Note 9)	24,353,323	20,049,135
Permanently restricted (Note 9)	2,232,958	2,082,424
Total net assets	675,609,947	630,189,634
Total liabilities and net assets	$ 1,508,510,883	$ 1,221,317,666

See accompanying notes to
consolidated financial statements

PEACEHEALTH

CONSOLIDATED STATEMENTS OF OPERATIONS

FOR THE YEARS ENDED JUNE 30, 2005 AND 2004

	2005	2004
Revenues:		
Net patient service revenues	$ 953,685,912	$ 859,117,407
Other operating revenue	25,027,531	26,388,774
Total revenues	978,713,443	885,506,181
Expenses:		
Salaries and wages	428,273,128	391,551,322
Payroll taxes and benefits	111,818,525	101,979,288
Professional fees	5,893,941	5,712,447
Supplies and other expenses	292,345,512	269,511,329
Provision for bad debts	29,838,560	25,556,238
Depreciation and amortization of other assets	51,084,823	47,179,570
Interest and amortization of deferred financing costs	19,233,793	8,951,802
Total expenses	938,488,282	850,441,996
Excess of revenues over expenses from operations before antitrust judgment (Note 11)	40,225,161	35,064,185
Antitrust judgment (Note 11)	16,900,000	-
Excess of revenues over expenses from operations after antitrust judgment (Note 11)	23,325,161	35,064,185
Other income:		
Investment income, net (Notes 2 and 3)	18,624,008	18,388,128
Gain (loss) on investments recorded on the equity method	1,687,403	(1,939,330)
Loss on refinancing	(2,194,474)	-
Other	479,653	(1,396,868)
Total other income, net	18,596,590	15,051,930
Excess of revenues over expenses	41,921,751	50,116,115
Change in net unrealized gains / losses on investments (Note 3)	18,820,993	18,322,614
Valuation adjustments on swap arrangements	(20,409,748)	6,972,300
Net assets released from restrictions used for purchase of property and equipment	1,453,809	1,699,225
Other change in unrestricted net assets	(821,214)	(166,239)
Increase in unrestricted net assets	$ 40,965,591	$ 76,944,015

See accompanying notes to
consolidated financial statements

PEACEHEALTH

CONSOLIDATED STATEMENTS OF CHANGES IN NET ASSETS

FOR THE YEARS ENDED JUNE 30, 2005 AND 2004

	UNRESTRICTED	TEMPORARILY RESTRICTED	PERMANENTLY RESTRICTED	TOTAL
Net assets at June 30, 2003	$ 531,114,060	$ 10,836,536	$ 2,882,524	$ 544,833,120
Excess of revenues over expenses	50,116,115	-	-	50,116,115
Change in net unrealized gains / losses on investments	18,322,614	-	-	18,322,614
Valuation adjustments on swap arrangements	6,972,300	-	-	6,972,300
Restricted contributions	-	2,185,107	132,905	2,318,012
Net assets released from restrictions used for the purchase of property and equipment	1,699,225	(1,699,225)	-	-
Net assets released from restrictions used for operations	-	(1,577,811)	-	(1,577,811)
Change in interest in net assets of related foundations (Note 2)	-	10,670,175	(933,005)	9,737,170
Other change in net assets	(166,239)	(365,647)		(531,886)
Change in net assets	76,944,015	9,212,599	(800,100)	85,356,514
Net assets at June 30, 2004	608,058,075	20,049,135	2,082,424	630,189,634
Excess of revenues over expenses	41,921,751	-	-	41,921,751
Change in net unrealized gains / losses on investments	18,820,993	-	-	18,820,993
Valuation adjustments on swap arrangements	(20,409,748)	-	-	(20,409,748)
Restricted contributions	-	2,095,715	-	2,095,715
Net assets released from restrictions used for the purchase of property and equipment	1,453,809	(1,453,809)	-	-
Net assets released from restrictions used for operations	-	(695,711)	-	(695,711)
Change in interest in net assets of related foundations (Note 2)	(740,351)	4,073,562	150,534	3,483,745
Other change in net assets	(80,863)	284,431	-	203,568
Change in net assets	40,965,591	4,304,188	150,534	45,420,313
Net assets at June 30, 2005	$ 649,023,666	$ 24,353,323	$ 2,232,958	$ 675,609,947

See accompanying notes to
consolidated financial statements

PEACEHEALTH

CONSOLIDATED STATEMENTS OF CASH FLOWS
FOR THE YEARS ENDED JUNE 30, 2005 AND 2004

	2005	2004
Cash flows from operating activities:		
Change in net assets	$ 45,420,313	$ 85,356,514
Adjustments to reconcile change in net assets to net cash provided by operating activities:		
Depreciation and amortization	51,724,643	47,742,607
Loss on sale of property, plant and equipment	(171,415)	547,427
Provision for bad debts	29,838,560	25,556,238
Restricted contributions	(2,095,715)	(2,318,012)
Net unrealized gains on investments	(18,820,993)	(18,322,614)
Valuation adjustments on swap arrangements	20,409,748	(6,972,300)
Loss on refinancing	1,269,474	-
Equity investment (gain) loss	(1,687,403)	1,939,330
(Increase) decrease in interest in net assets of related foundations	(3,483,745)	(9,737,170)
Changes in operating assets and liabilities:		
(Increase) decrease in:		
Accounts receivable, net	(41,166,618)	(36,864,267)
Inventory of supplies	(863,411)	(1,290,261)
Prepaid expenses and other current assets	(99,729)	(1,434,119)
Increase (decrease) in:		
Accounts payable	2,632,365	(19,004,494)
Accrued payroll, payroll taxes and employee benefits	14,761,133	5,563,525
Accrued interest payable	(782,660)	(173,525)
Other current liabilities	377,592	3,520
Reimbursement settlements payable	(3,463,700)	(3,585,213)
Other liabilities	44,514,711	10,826,561
Net cash provided by operating activities	138,313,150	77,833,747
Cash flows from investing activities:		
Purchase of property, plant and equipment	(81,925,758)	(77,700,616)
Proceeds from sale of property, plant and equipment	429,219	142,797
Purchase of investments	(235,989,052)	(96,343,052)
Sale of investments	59,158,916	105,009,034
(Increase) decrease in assets whose use is limited, other	(17,734,177)	2,445,019
Decrease (increase) in other assets	5,073,228	(5,806,477)
Net cash used by investing activities	(270,987,624)	(72,253,295)
Cash flows from financing activities:		
Proceeds from long-term borrowings	208,350,000	587,532
Principal payments on long-term debt	(7,966,314)	(7,759,920)
Proceeds from restricted contributions	2,095,715	2,318,012
Advance repayment of long-term debt	(46,250,000)	-
Increase in deferred financing costs	(4,947,379)	(46,848)
Net cash used by financing activities	151,282,022	(4,901,224)
Net increase in cash and cash equivalents	18,607,548	679,228
Cash and cash equivalents at beginning of year	15,579,695	14,900,467
Cash and cash equivalents at end of year	$ 34,187,243	$ 15,579,695
Supplemental disclosure of non-cash activities: The Corporation entered into securities lending agreements with certain collateral and payable requirements.	$ 109,427,291	$ 79,827,514

See accompanying notes to
consolidated financial statements

PEACEHEALTH

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

JUNE 30, 2005 and 2004

1. Organization

PeaceHealth (the Corporation) is a Washington not-for-profit corporation with its corporate office located in Bellevue, Washington, is sponsored by the Sisters of St. Joseph of Peace and is recognized to be a Private Pontifical Juridic Person by the Roman Catholic Church. At June 30, 2005, the following regional healthcare delivery systems and operating divisions were components of the Corporation:

PeaceHealth Oregon Region, Eugene, Oregon
- Sacred Heart Medical Center
- Cottage Grove Hospital
- PeaceHealth Medical Group
- South Lane Medical Group

PeaceHealth Siuslaw Region, Florence, Oregon
- Peace Harbor Hospital
- Health Associates of Peace Harbor

PeaceHealth Lower Columbia Region, Longview, Washington
- St. John Medical Center
- PeaceHealth Medical Group

PeaceHealth Whatcom Region, Bellingham, Washington
- St. Joseph Hospital
- St. Joseph Medical Group

PeaceHealth Alaska Region, Ketchikan, Alaska
- Ketchikan General Hospital and Medical Clinics
- Island View Manor Nursing Home

Oregon Medical Laboratories

These healthcare delivery systems and operating divisions, along with the Corporation's home office, form the obligated group and are not separate legal entities. The assets of any one are available for the satisfaction of debts of the entire Corporation (subject to the limitations of certain contractual commitments).

Health Ventures is a not-for-profit corporation that has entered into joint ventures to provide radiology and oncology services. The Corporation is the sole member of Health Ventures. Health Ventures is included in the consolidated financial statements but is not part of the obligated group.

The Corporation is a minority partner in both Premier Purchasing Partners (Premier) and American Excess Insurance Exchange (AEIX). The Corporation has invested in Premier with other healthcare providers for the purpose of lowering costs through group purchasing. The Corporation accounts for its interest in Premier on the cost method. AEIX is owned by a group of healthcare providers and provides them with excess professional liability insurance coverage. The Corporation accounts for its interest in AEIX on the equity method.

As of June 30, 2005 and 2004 the carrying value of Premier and AEIX was $6,846,000 and $5,159,000, respectively and is recorded in investments in joint ventures and other on the consolidated balance sheets.

2. Summary of significant accounting policies

Consolidation - The consolidated financial statements include the accounts of the Corporation and its controlled affiliates. All significant intercompany transactions and balances have been eliminated.

Estimates - The preparation of financial statements in conformity with accounting principals generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. The significant estimates in the Corporation's consolidated financial statements include accounts receivable allowances, third party payer settlement liabilities, accrued liabilities for the antitrust judgment (see footnote 11) and liabilities related to self-insurance programs (see footnote 13).

Cash and cash equivalents - Cash and cash equivalents consist of petty cash, cash in demand bank accounts and all highly liquid debt instruments purchased with an original maturity of three months or less other than those whose use is limited. The Corporation held cash equivalents of approximately $30,543,000 and $14,240,000 as of June 30, 2005 and 2004.

Short-term investments - Short-term investments consisting primarily of U.S. Government and other investment grade securities are carried at fair value. Investment income or loss (including realized gains and losses, other than temporary unrealized losses, interest and dividends) is included in the excess of revenues over expenses. Unrealized gains and temporary unrealized losses are excluded from the excess of revenues over expenses and are shown as a change in unrestricted net assets.

Inventory of supplies - Inventory is valued based on the most recent price received.

Assets whose use is limited - These items consist of trustee held funds, investments in marketable stocks and bonds, mutual funds, investments in joint ventures, investments in expansion property and loans to others. Money market funds and all marketable securities have readily determined market values and are therefore carried at market value. The investments in joint ventures and other are accounted for using the equity or cost method.

Property, plant and equipment - Property, plant and equipment are stated at cost. Improvements and replacements of plant and equipment are capitalized. Maintenance and repairs are expensed as they are incurred. When property, plant and equipment is sold or retired, the cost and the related accumulated depreciation are removed from the accounts, and the resulting gain or loss is recorded.

Medical office buildings and other - These properties consist of medical offices and other rental buildings and land held for future development. These assets, other than land, are depreciated using the straight-line method over periods of 3 to 40 years.

Depreciation - Depreciation on property, plant and equipment is computed using the straight-line method over the following estimated useful lives:

Land improvements	5 - 20 years
Buildings and improvements	5 - 50 years
Fixed equipment	10 - 25 years
Leasehold improvements	Shorter of remaining length of the lease or useful life
Moveable equipment	3 - 15 years

Deferred financing costs - These costs are amortized over the lives of the related debt issues using the straight-line method which approximates the effective interest method.

Other assets – Goodwill recorded in connection with the purchase of certain assets is included in other assets. Goodwill is amortized using the straight-line method over its estimated useful life of two to five years. Other assets also includes the cash surrender value of life insurance on various employees in the Corporation and unvested deferred compensation and had a carrying value of approximately $15,884,000 and $15,690,000 as of June 30, 2005 and 2004, respectively.

Donations and grants - Unrestricted donations and grants are recorded as other operating revenues. Donor-restricted donations and grants are recorded as additions to the appropriate class of net assets. When capital expenditures are made consistent with the purpose intended by the donor, a transfer is made from temporarily restricted net assets to unrestricted net assets. If restricted amounts are expended for operations, the amounts are recorded as other operating revenues.

Interest in Net Assets of Related Foundations - The Corporation accounts for activities with its related foundations under Statement of Financial Accounting Standards No. 136, "Transfers of Assets to a Not-For-Profit Organization or Charitable Trust That Raises or Holds Contributions for Others" (SFAS 136). SFAS 136 requires the Corporation to recognize its interests in the net assets of its related foundations.

Net patient service revenues - The Corporation has agreements with third party payers that provide for payments of amounts different from established charges. The Corporation's net patient service revenue came from the following sources:

	2005	2004
Medicare	36.6%	36.8%
Medicaid	8.4%	8.4%
Commercial & Other	51.0%	49.6%
Private Pay	4.0%	5.2%
	100%	100%

The Corporation has estimated payments for services rendered to Medicare and Medicaid patients during the year by applying the payment principles of the applicable governmental agencies and believes that an adequate provision has been made in the accompanying financial statements for final settlement. Estimates of final settlements to Medicare, Medicaid and other third party payers have been reflected as a reimbursement settlement payable in the accompanying balance sheets. Differences between the net amounts accrued and subsequent settlements are recorded in operations at the time of settlement.

Reimbursement for inpatient services rendered to Medicare recipients has been made principally under a prospective pricing system based on diagnosis-related groups. Payments for certain exempt inpatient units are based on defined allowable costs. Most outpatient services provided to Medicare patients are reimbursed based on prospectively determined rates.

Services to Medicaid patients are reimbursed based on a combination of prospectively determined rates and cost reimbursement methodology.

Continuation of these reimbursement programs at the present level, and on the present basis, is dependent upon future policies of federal and state governmental agencies.

The Corporation has also entered into payment agreements with certain commercial insurance carriers, health maintenance organizations and preferred provider organizations. The basis for payment to the Corporation under these agreements includes prospectively determined rates per unit of service and discounts from established charges. Most arrangements provide for payment or reimbursement to the Corporation at amounts different than established rates. Contractual discounts represent the difference between established rates for services and amounts paid or reimbursed by these third-party payers.

Other operating revenue - Other operating revenue includes revenue from nonpatient care services and clinical space rental revenues.

Federal and State income taxes - The Corporation has received a determination letter from the Internal Revenue Service stating that it is exempt from Federal income tax under Section 501(c)(3) of the Internal Revenue Code except for tax on unrelated business income. It is management's belief that none of its activities have produced material unrelated business income.

3. Investments

Assets Whose Use is Limited

The composition of cash and investments included in assets whose use is limited at June 30, 2005 and 2004, is set forth in the following table. Investments are stated at fair value.

	2005	2004
Designated for capital acquisition:		
Cash and fixed income	$217,815,687	$184,856,291
Equity securities	205,428,575	185,514,993
	423,244,262	370,371,284
Trustee held funds:		
Cash and short-term investments	11,445,203	7,155,367
Fixed income	123,333,749	19,504,500
Equity securities	26,883,060	20,544,064
	161,662,012	47,203,931
Other investments:		
Cash and short-term investments	822,983	454,998
	$585,729,257	$418,030,213

Investment income and gains for cash and investments included in assets whose use is limited are comprised of the following for the years ending June 30, 2005 and 2004.

	2005	2004
Included in investment income:		
Interest income	$16,798,129	$11,629,133
Net realized gain (loss) on sales of securities	(1,458,316)	1,751,373
	$15,339,813	$13,380,506
Included in changes in unrestricted net assets:		
Change in net unrealized gains / losses on investments	$18,825,725	$20,037,868

Securities Lending Agreements

The Corporation has entered into securities lending agreements whereby a portion of investments are loaned to various brokers in return for cash and securities from the broker as collateral for the securities loaned. Pursuant to this agreement, the collateral received must always equal at least 102% of the market value of the securities loaned, which is determined at the end of each business day. The securities on loan are comprised entirely of marketable debt securities.

4. **Charity care**

The Corporation maintains records to identify and monitor the level of charity care it provides. Charges forgone for services and supplies furnished under the charity care policy for the years ended June 30, 2005 and 2004 were approximately $49,482,000 and $36,510,000 respectively.

5. **Accounts receivable**

Accounts receivable at June 30 consisted of the following:

	2005	2004
Patient accounts receivable	$237,855,414	$214,769,733
Less:		
Allowance for doubtful accounts	(45,860,968)	(34,914,304)
Allowance for estimated contractual discounts	(64,264,418)	(59,890,188)
Net patient accounts receivable	127,730,028	119,965,241
Sundry accounts receivable	5,644,643	2,081,372
Accounts receivable, net	$133,374,671	$122,046,613

6. **Long-term debt**

Long-term debt at June 30 consisted of the following:

	2005	2004
Series 1993 Washington Bonds, variable interest rate, (2.22% at June 30, 2005) payable each April 1, due in annual installments through 2018, maturing April 1, 2018.	$18,200,000	$19,100,000
Series 1994 Washington Bonds, 5.30%, Interest payable each March 1 and September 1, due in annual installments through 2009, maturing March 1, 2009.	4,565,000	5,570,000
Series 1994 Oregon Bonds, 5.625%, interest payable each February 1 and August 1, due in annual installments through 2007, maturing August 1, 2007.	7,450,000	55,930,000
Series 1995 Oregon Bonds, variable interest rate, (2.27% at June 30, 2005) payable each December 1, due in annual installments through 2015, maturing December 1, 2015.	10,925,000	11,625,000
Series 1995 Washington Bonds, 5.00% to 5.625%, interest payable each May 15 and November 15, due in annual installments through 2015, maturing November 15, 2015.	20,045,000	21,365,000

Series 1998 Washington Bonds, 5.00%, interest payable each May 15 and November 15, due in annual installments through 2028, maturing November 15, 2028.	60,000,000	60,000,000
Series 1998 Oregon Bonds, variable interest rate, (2.27% at June 30, 2005) payable each December 1, due in annual installments through 2028, maturing December 1, 2028.	13,500,000	13,800,000
Series 2001 Washington Bonds, variable interest rate, (2.30% on $40 million and 2.35% on $40 million, at June 30, 2005) payable each November 15, due in annual installments through 2032, maturing November 15, 2032.	80,000,000	80,000,000
Series 2001 Oregon Bonds, 5.00% to 5.25%, interest payable each May 15 and November 15, due in annual installments through 2032, maturing November 15, 2032.	70,000,000	70,000,000
Series 2004 Oregon Bonds, Series A ($15,000,000) 3.00% to 5.00%, interest payable each February 1 and August 1, due in annual installments from 2010 to 2014. Series B-F ($193,350,000), variable interest rate (2.25% to 2.40% at June 30, 2005), due in annual installments through 2034, maturing August 1, 2034.	208,350,000	-
Other long-term debt	8,013,983	9,525,297
Total long-term debt	501,048,983	346,915,297
Less amounts due within one year	(7,845,056)	(7,952,265)
Total long-term debt due after one year	$493,203,927	$338,963,032

The Series 1993 Washington, 1995 Oregon, 1998 Oregon, 2001 Washington bonds and a portion of the 2004 Oregon bonds have variable interest rates that may bear interest at a daily, weekly, 28 day, monthly, semi-annual, annual or fixed rates. The rate determination mode may be changed upon request of the Corporation. The bonds are subject to optional redemption by PeaceHealth, in whole or in part at 100% of the principal amount plus interest. The Corporation has a standby bond purchase agreement or letter of credit agreement for the 1993, 1995 and 1998 variable rate demand bonds for the amount of the outstanding principal plus accrued interest. The 2001 auction rate bonds do not require a standby bond purchase agreement. The Series 2004 Oregon bonds consist of six series of bonds, five of which are auction rate bonds with a total par amount of $193,350,000 that have fixed payer swaps associated with them with rates ranging from 3.23% to 3.69%, and $15,000,000 of traditional fixed bonds that have coupons which range from 3.00% to 5.00%, which in aggregate were priced to yield 3.3%.

During 2005, the Corporation refinanced $46,250,000 of the outstanding amount of the Series 1994 Oregon Bonds (the 1994 bonds) which resulted in a loss on refinancing of $2,194,474. The loss on refinancing consists of $1,269,474 of unamortized financing costs associated with the refinanced 1994 bonds and $925,000 of call-premium and has been included in other non-operating income in the accompanying consolidated statement of operations in 2005.

In accordance with the requirements of the Bond Trust Indentures at June 30, the following funds were held by trustees:

	2005	2004
Principal and interest funds	$6,490,505	$3,842,499
Project funds	96,589,762	-
Debt service reserve funds	1,311,861	1,311,844
	$104,392,128	$5,154,343

These trustee-held funds are included in assets whose use is limited in the accompanying consolidated balance sheets.

The Master Trust Indenture, the loan agreements and other contractual documents under which the Corporation's bonds were issued include covenants, which among others, obligate the Corporation to: maintain net patient service revenues at levels sufficient to achieve specified debt service coverage ratios; meet certain financial tests before additional debt can be incurred; and to meet certain financial tests before there can be any significant disposition of property.

Scheduled aggregate maturities of long-term debt subsequent to June 30, 2005 are as follows:

Year ending June 30	
2006	$ 7,845,056
2007	$ 6,858,458
2008	$ 7,303,713
2009	$ 4,926,756
2010	$ 6,414,463
Thereafter	$467,700,537
Total	$501,048,983

Cash paid for interest totaled approximately $20,655,000 and $13,541,000 for the years ended June 30, 2005 and 2004, respectively. Interest totaling approximately $1,278,000 and $2,096,000 was capitalized in connection with construction projects during the years ended June 30, 2005 and 2004, respectively.

7. Accounting for derivative instruments and hedging activities

In accordance with the policy adopted by the Board of Directors, the Corporation may use interest rate swap contracts to manage its net exposure to interest rate changes in attempting to reduce its overall cost of borrowing over time. Interest rate swap contracts generally involve the exchange of fixed and floating interest rate payments without the exchange of underlying principal (the swap of fixed or floating rates are on a "notional" amount). The Corporation accounts for its interest rate hedging transactions in accordance with Statement of Financial Accounting Standards No. 133 (SFAS 133) "Accounting for Derivative Instruments and Hedging Activities". The standard requires that every derivative instrument be recorded on the balance sheet as either an asset or liability measured at its fair market value. The standard requires that changes in the derivative instrument's fair market value be recognized currently in earnings unless specific hedge accounting criteria are met. Accounting for qualifying fair value hedges allows a derivative instrument's gains and losses to offset related results on the hedged item in the statement of operations, to the extent effective, and for qualifying cash flow hedges the change in the value of the swap to be reported as a component of changes in net assets. The Corporation has formally documented, designated and assessed the effectiveness of transactions that receive hedge accounting treatment.

The Corporation has entered into various interest rate management transactions as of June 30, 2005 with a total notional amount of $319,350,000, which included the following: a basis swap on $40,000,000 of variable rate bonds which exchanges the interest rate paid from one variable rate to another, $193,350,000 of cash flow hedges (fixed payer swaps) which convert variable rates to fixed rates for the 2004 Oregon bonds and $86,000,000 of forward starting cash flow hedges (fixed payer swaps) related to the anticipated issuance of the Washington 2005 bonds.

The Corporation evaluated the cash flow hedges and determined that they meet the criteria to be classified as a hedge of a forecasted transaction or a current cash flow hedge and have accounted for them as cash flow hedges in the accompanying financial statements.

The basis swap does not qualify for hedge accounting treatment and its change in market value and associated cash flows are included as a component of interest expense which amounted to an additional expense of $822,000 in fiscal 2005, and which was a reduction of interest expense in the amount of $938,100 in 2004.

In 2005 the Corporation terminated its $25,000,000 fair value hedge by electing to receive a fair value payment of $805,000.

All of the outstanding interest rate swap transactions allow PeaceHealth to terminate the financial instruments by requiring full settlement of any interest or termination value, upon 10 days notice given on the first business day of each month. The counterparty can terminate the swaps, requiring full settlement of any interest or termination value, only if the Corporation's credit rating falls to BBB- or equivalent.

In measuring the swaps at fair value, the Corporation has recorded a net valuation liability of $15,771,200 and a net asset of $6,193,500 as of June 30, 2005 and 2004, respectively, which have been recorded in the accompanying balance sheets.

8. Medicare and Medicaid revenue

Net revenue for services provided to Medicare patients for the years ended June 30, 2005 and 2004 was approximately $348,796,000 and $315,961,000 respectively. Medicaid net patient service revenue for the years ended June 30, 2005 and 2004 was approximately $80,450,000 and $72,525,000 respectively. Laws and regulations governing the Medicare and Medicaid programs are extremely complex and subject to interpretation. As a result, recorded estimates may change by a material amount in the near term. Net patient service revenues increased by approximately $10,900,000 and $9,000,000 in 2005 and 2004, respectively, due to removal of allowances and additional reimbursement related to prior years.

The Medicare cost reports are ordinarily subject to retroactive adjustment for three years after settlement, unless held open longer for disputed items. The reimbursement reports receive either full or limited scope audits by the fiscal intermediary appointed by Medicare. Settlements for open years will be finalized after review by the appropriate government agencies.

9. Restricted Net Assets

Restricted net assets are those whose use by the Corporation has been limited by donor imposed restrictions to a specific time period and/or purpose. Permanently restricted net assets have been restricted by donors to be maintained in perpetuity.

Temporarily and permanently restricted net assets are available for the following purposes at June 30:

	2005	2004
Purchase of property, plant and equipment	$22,271,306	$18,426,218
Indigent care	285,321	371,356
Patient care operating activities	3,818,630	2,941,614
Other	211,024	392,371
	$26,586,281	$22,131,559

During fiscal year 2005 and 2004, net assets were released from donor restrictions by incurring expenses satisfying the restricted purposes of indigent care and health care education of approximately $804,000 and $1,578,000, respectively. Further, approximately $1,454,000 and $1,699,000 of capital expenditures were made during 2005 and 2004, respectively, that met the guidelines stipulated for reimbursement from donated funds.

10. Retirement plan

The Corporation has a defined contribution retirement plan which covers substantially all employees meeting certain age and length of service requirements. Total retirement plan costs charged to operations were approximately $25,118,000 and $21,782,000 for the years ended June 30, 2005 and 2004, respectively and is included in payroll taxes and benefits in the accompanying consolidated statements of operations.

11. Antitrust judgment

PeaceHealth was sued by McKenzie-Willamette Hospital of Springfield Oregon in the federal district court for the district of Oregon under cause number CV No.: 02-6032-HA. The claims included violation of federal antitrust and other laws. After trial on the money-damages portion of the lawsuit, the jury returned a verdict in favor of the plaintiff on the following three of the seven claims it had alleged: attempted monopolization, price discrimination and wrongful interference. The jury awarded alternative damages, and McKenzie-Willamette Hospital elected damages in the amount of $5.4 million, which if upheld will be trebled in accordance with the antitrust law (total of $16.2 million). The court has entered a judgment on the verdict, which is currently under appeal by PeaceHealth with the 9th Circuit Court of Appeals. Because of the uncertain nature of litigation assessments, the Corporation has recorded a liability for the full amount of the damages, including interest, but it intends to aggressively pursue the appeal based on the opinion of counsel that error was committed at the trial court level. The non-monetary portion of the case which sought equitable relief has been fully settled for a nominal amount.

12. Commitments and contingent liabilities

In September 1998, the Corporation sold its joint venture interests in Willamette Oaks and Bellewood retirement apartments, however, as of June 30, 2005, the Corporation remains liable as a guarantor for $8,090,000 of mortgage debt related to Bellewood.

The Corporation leases, for a nominal amount, the buildings and certain equipment for Ketchikan General Hospital from the City of Ketchikan, Alaska under a ten-year lease which expires in 2013.

The Corporation has begun a project to improve its current facilities and construct a replacement facility, RiverBend, for a substantial portion of services for Sacred Heart Medical Center which is part of its Oregon Region. The Corporation has spent $109,666,000 as of June 30, 2005 and expects the entire project to cost over $612,700,000 and extend through fiscal year 2008. The Corporation has entered into construction and other commitments for approximately $102,954,000 as of June 30, 2005 related to this project.

The healthcare industry is governed by various laws and regulations of federal, state and local governments. These laws and regulations are subject to on-going government review and interpretation, as well as regulatory actions unknown or unasserted at this time. The Corporation is also involved in litigation and regulatory investigations arising in the course of business. After consultation with legal counsel, management estimates that these matters will be resolved without material adverse effect on the Corporation's future financial position or results from operations.

13. Insurance coverages

The Corporation has a self-insurance program for hospital and physician professional and general liability claims under which the Corporation contributes actuarially determined amounts to a trust to fund estimated ultimate losses. In connection with the self-insurance program, the Corporation has accrued estimates for asserted and incurred but not reported claims. The claims liability has been discounted to present value using a discount rate of 6%. Self-insured professional and general liability retention in 2005 and 2004 was $5,000,000 per occurrence and $18,000,000 in aggregate. Individual general and professional liability claims in excess of the above self-insured retention levels are insured through a claims made excess insurance policy (note 1).

Effective June 1, 2003 the Corporation expanded its physician professional self-insured liability to include the primary coverage for the first $2,000,000 of losses that was previously insured through an external carrier.

The Corporation also self-insures all or a portion of liabilities related to its medical and dental benefit plans, unemployment and worker's compensation claims. Funding levels are determined based on an actuarial study.

Funded amounts for all self-insured plans, $56,825,000 at June 30, 2005 and $41,610,000 at June 30, 2004, are held in trust and are included in assets whose use is limited. The self-insurance reserve is included in other long-term liabilities on the consolidated balance sheets.

14. Fair value of financial instruments

At June 30, 2005 and 2004, the Corporation's carrying amount and fair value of financial instruments were as follows:

	2005		2004	
	Carrying Value	Fair Value	Carrying Value	Fair Value
Short-Term Investments	$76,414,366	$76,414,366	$48,462,281	$48,462,281
Securities Lending Agreements	109,427,291	109,427,291	79,827,514	79,827,514
Limited Use Investments	585,729,257	585,729,257	418,030,213	418,030,213
Loans Receivable	1,809,503	1,853,829	1,893,685	2,138,367
Long-Term Debt	501,048,983	509,352,435	346,915,297	345,180,833

Cash and Cash Equivalents - The carrying amount approximates fair value because of the short maturity of those instruments.

Investments - The fair value of investments equals quoted market price. If a quoted market price is not available, fair value is estimated using quoted market prices for similar securities.

Loans Receivable - The fair value is estimated by discounting future cash flows using the current rate at which similar loans would be made to borrowers with similar credit ratings and for the same remaining maturities.

Securities Lending Agreements - The carrying amount approximates fair value because of the short maturity of those instruments.

Long-Term Debt - Rates currently available to the Corporation for debt with similar terms and remaining maturities are used to estimate fair value of debt.

Guaranteed Debt - The Corporation assumes that it would settle debt guarantees at the carrying cost if such guarantees were enforced (note 11).

Financial Derivatives – The fair value of derivative financial instruments are developed from quoted market prices for similar instruments (note 7).

PEACEHEALTH

CONSOLIDATED FINANCIAL STATEMENTS

FOR YEARS ENDED JUNE 30, 2006 AND 2005

TABLE OF CONTENTS

KPMG

KPMG LLP
Suite 900
801 Second Avenue
Seattle, WA 98104

Independent Auditors' Report

To the Board of Directors
of PeaceHealth:

We have audited the accompanying consolidated balance sheets of PeaceHealth (the Corporation) (a Washington not-for-profit corporation) as of June 30, 2006 and 2005, and the related consolidated statements of operations, changes in net assets, and cash flows for the years then ended. These consolidated financial statements are the responsibility of the Corporation's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Corporation's internal control over financial reporting. Accordingly, we express no such opinion. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of PeaceHealth as of June 30, 2006 and 2005, and the results of its operations, changes in net assets and cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

KPMG LLP

September 1, 2006

KPMG LLP, a U.S. limited liability partnership, is the U.S. member firm of KPMG International, a Swiss cooperative.

LIABILITIES AND NET ASSETS	2006	2005
Current liabilities:		
Accounts payable	$ 58,385,130	$ 35,703,417
Accrued payroll, payroll taxes and employee benefits	72,523,048	78,626,723
Accrued interest payable	1,616,677	1,742,203
Other current liabilities	27,383,921	21,242,780
Reimbursement settlements payable	20,206,158	11,004,132
Payable under securities lending agreement (Note 3)	60,228,138	109,427,291
Current portion of long-term debt (Note 6)	6,858,458	7,845,056
Total current liabilities	247,201,530	265,591,602
Other liabilities (Note 11 and 12)	65,869,950	74,105,407
Long-term debt due after one year (Note 6)	493,687,289	493,203,927
Commitments and contingent liabilities (Note 12)		
Net assets:		
Unrestricted	752,222,275	649,023,666
Temporarily restricted (Note 9)	30,404,281	24,353,323
Permanently restricted (Note 9)	2,442,438	2,232,958
Total net assets	785,068,994	675,609,947
Total liabilities and net assets	$ 1,591,827,763	$ 1,508,510,883

See accompanying notes to
consolidated financial statements

PEACEHEALTH

CONSOLIDATED STATEMENTS OF OPERATIONS

FOR THE YEARS ENDED JUNE 30, 2006 AND 2005

	2006	2005
Revenues:		
Net patient service revenues	$ 1,015,809,743	$ 953,685,912
Other operating revenue	32,895,792	25,027,531
Total revenues	1,048,705,535	978,713,443
Expenses:		
Salaries and wages	451,353,324	428,273,128
Payroll taxes and benefits	122,802,298	111,818,525
Professional fees	4,936,130	5,893,941
Supplies and other expenses	321,038,356	292,345,512
Provision for bad debts	36,371,060	29,838,560
Depreciation and amortization of other assets	52,723,782	51,084,823
Interest and amortization of deferred financing costs	10,395,945	19,233,793
Total expenses	999,620,895	938,488,282
Excess of revenues over expenses from operations before antitrust judgment (Note 11)	49,084,640	40,225,161
Antitrust judgment (Note 11)	-	16,900,000
Excess of revenues over expenses from operations after antitrust judgment (Note 11)	49,084,640	23,325,161
Other income:		
Investment income, net (Notes 2 and 3)	49,545,860	18,624,008
Gain on investments recorded on the equity method	314,400	1,687,403
Loss on refinancing	(6,667,691)	(2,194,474)
Other	982,531	479,653
Total other income, net	44,175,100	18,596,590
Excess of revenues over expenses	93,259,740	41,921,751
Change in net unrealized gains / losses on investments (Note 3)	(1,955,982)	18,820,993
Valuation adjustments on swap arrangements	20,967,000	(20,409,748)
Net assets released from restrictions used for purchase of property and equipment	2,465,800	1,453,809
Cumulative effect of change in accounting principle (Note 2)	(11,537,949)	-
Other change in unrestricted net assets	-	(821,214)
Increase in unrestricted net assets	$ 103,198,609	$ 40,965,591

See accompanying notes to consolidated financial statements

PEACEHEALTH

CONSOLIDATED STATEMENTS OF CHANGES IN NET ASSETS

FOR THE YEARS ENDED JUNE 30, 2006 AND 2005

	UNRESTRICTED	TEMPORARILY RESTRICTED	PERMANENTLY RESTRICTED	TOTAL
Net assets at June 30, 2004	$ 608,058,075	$ 20,049,135	$ 2,082,424	$ 630,189,634
Excess of revenues over expenses	41,921,751	-	-	41,921,751
Change in net unrealized gains / losses on investments	18,820,993	-	-	18,820,993
Valuation adjustments on swap arrangements	(20,409,748)	-	-	(20,409,748)
Restricted contributions	-	2,095,715	-	2,095,715
Net assets released from restrictions used for the purchase of property and equipment	1,453,809	(1,453,809)	-	-
Net assets released from restrictions used for operations	-	(695,711)	-	(695,711)
Change in interest in net assets of related foundations (Note 2)	(740,351)	4,073,562	150,534	3,483,745
Other change in net assets	(80,863)	284,431	-	203,568
Change in net assets	40,965,591	4,304,188	150,534	45,420,313
Net assets at June 30, 2005	649,023,666	24,353,323	2,232,958	675,609,947
Excess of revenues over expenses	93,259,740	-	-	93,259,740
Change in net unrealized gains / losses on investments	(1,955,982)	-	-	(1,955,982)
Valuation adjustments on swap arrangements	20,967,000	-	-	20,967,000
Restricted contributions	-	2,866,658	-	2,866,658
Net assets released from restrictions used for the purchase of property and equipment	2,465,800	(2,465,800)	-	-
Net assets released from restrictions used for operations	-	(359,147)	-	(359,147)
Cumulative effect of change in accounting principle	(11,537,949)	-	-	(11,537,949)
Change in interest in net assets of related foundations (Note 2)	-	6,009,247	209,480	6,218,727
Change in net assets	103,198,609	6,050,958	209,480	109,459,047
Net assets at June 30, 2006	$ 752,222,275	$ 30,404,281	$ 2,442,438	$ 785,068,994

See accompanying notes to consolidated financial statements

PEACEHEALTH

CONSOLIDATED STATEMENTS OF CASH FLOWS
FOR THE YEARS ENDED JUNE 30, 2006 AND 2005

	2006	2005
Cash flows from operating activities:		
Change in net assets	$ 109,459,047	$ 45,420,313
Adjustments to reconcile change in net assets to net cash provided by operating activities:		
Depreciation and amortization	53,329,513	51,724,643
Gain on sale of property, plant and equipment	(100,926)	(171,415)
Provision for bad debts	36,371,060	29,838,560
Restricted contributions	(2,591,658)	(2,095,715)
Net unrealized losses (gains) on investments	1,955,982	(18,820,993)
Valuation adjustments on swap arrangements	(20,967,000)	20,409,748
Loss on refinancing	2,965,591	1,269,474
Equity investment gain	(314,400)	(1,687,403)
Increase in interest in net assets of related foundations	(6,218,727)	(3,483,745)
Cumulative effect of change in accounting principle	11,537,949	-
Changes in operating assets and liabilities:		
(Increase) decrease in:		
Accounts receivable, net	(40,124,779)	(41,166,618)
Inventory of supplies	(3,090,130)	(863,411)
Prepaid expenses and other current assets	(3,122,662)	(99,729)
Increase (decrease) in:		
Accounts payable	7,217,004	2,632,365
Accrued payroll, payroll taxes and employee benefits	(6,103,675)	14,761,133
Accrued interest payable	(125,526)	(782,660)
Other current liabilities	6,141,141	377,592
Reimbursement settlements payable	9,202,026	(3,463,700)
Other liabilities	(21,747,359)	44,514,711
Net cash provided by operating activities	133,672,471	138,313,150
Cash flows from investing activities:		
Purchase of property, plant and equipment	(177,227,413)	(81,925,758)
Proceeds from sale of property, plant and equipment	838,605	429,219
Purchase of investments	(362,376,699)	(235,989,052)
Sale of investments	381,079,420	59,158,916
Decrease (increase) in assets whose use is limited, other	14,743,693	(17,734,177)
Increase (decrease) in other assets	(3,397,127)	5,073,228
Net cash used by investing activities	(146,339,521)	(270,987,624)
Cash flows from financing activities:		
Proceeds from long-term borrowings	86,000,000	208,350,000
Principal payments on long-term debt	(7,848,236)	(7,966,314)
Proceeds from restricted contributions	2,591,658	2,095,715
Advance repayment of long-term debt	(78,655,000)	(46,250,000)
Increase in deferred financing costs	(1,914,130)	(4,947,379)
Net cash provided by financing activities	174,292	151,282,022
Net (decrease) increase in cash and cash equivalents	(12,492,758)	18,607,548
Cash and cash equivalents at beginning of year	34,187,243	15,579,695
Cash and cash equivalents at end of year	$ 21,694,485	$ 34,187,243

See accompanying notes to consolidated financial statements

PEACEHEALTH

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

JUNE 30, 2006 and 2005

1. Organization

PeaceHealth (the Corporation) is a Washington not-for-profit corporation with its corporate office located in Bellevue, Washington, is sponsored by the Sisters of St. Joseph of Peace and is recognized to be a Private Pontifical Juridic Person by the Roman Catholic Church. At June 30, 2006, the following regional healthcare delivery systems and operating divisions were components of the Corporation:

PeaceHealth Oregon Region, Eugene, Oregon
- Sacred Heart Medical Center
- Cottage Grove Hospital
- PeaceHealth Medical Group
- South Lane Medical Group

PeaceHealth Siuslaw Region, Florence, Oregon
- Peace Harbor Hospital
- Health Associates of Peace Harbor

PeaceHealth Lower Columbia Region, Longview, Washington
- St. John Medical Center
- PeaceHealth Medical Group

PeaceHealth Whatcom Region, Bellingham, Washington
- St. Joseph Hospital
- St. Joseph Medical Group

PeaceHealth Alaska Region, Ketchikan, Alaska
- Ketchikan General Hospital and Medical Clinics
- Island View Manor Nursing Home

Oregon Medical Laboratories

These healthcare delivery systems and operating divisions, along with the Corporation's home office, form the obligated group and are not separate legal entities. The assets of any one are available for the satisfaction of debts of the entire Corporation (subject to the limitations of certain contractual commitments).

Health Ventures is a not-for-profit corporation that has entered into joint ventures to provide radiology and oncology services. The Corporation is the sole member of Health Ventures. Health Ventures is included in the consolidated financial statements but is not part of the obligated group.

The Corporation is a minority partner in both Premier Purchasing Partners (Premier) and American Excess Insurance Exchange (AEIX). The Corporation has invested in Premier with other healthcare providers for the purpose of lowering costs through group purchasing. The Corporation accounts for its interest in Premier on the cost method. AEIX is owned by a group of healthcare providers and provides them with excess professional liability insurance coverage. The Corporation accounts for its interest in AEIX on the equity method.

As of June 30, 2006 and 2005 the carrying value of Premier and AEIX was approximately $7,160,000 and $6,846,000, respectively and is recorded in investments in joint ventures and other on the consolidated balance sheets.

In fiscal year 2006 the Corporation created a Real Estate Pooled Income Fund pursuant to IRS Code Sec. 642(c)(5). A pooled income fund is a trust to which donors transfer property, contributing an irrevocable remainder interest in such property to or for the use of a qualified charitable organization and retaining an income interest for the life of one or more beneficiaries. The Real Estate Pooled Income Fund uses the proceeds of all contributions to purchase buildings from the Corporation's obligated group, which are leased back to the Corporation's obligated group under a long-term master lease agreement. The Real Estate Pooled Income Fund is included in the consolidated financials statements but is not part of the obligated group.

2. Summary of significant accounting policies

Consolidation - The consolidated financial statements include the accounts of the Corporation and its controlled affiliates. All significant intercompany transactions and balances have been eliminated.

Estimates - The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. The significant estimates in the Corporation's consolidated financial statements include accounts receivable allowances, third party payer settlement liabilities, accrued liabilities for the antitrust judgment (see footnote 11) and liabilities related to self-insurance programs (see footnote 13).

Cash and cash equivalents - Cash and cash equivalents consist of petty cash, cash in demand bank accounts and all highly liquid debt instruments purchased with an original maturity of three months or less other than those whose use is limited. The Corporation held cash equivalents of approximately $3,701,000 and $30,543,000 as of June 30, 2006 and 2005.

Short-term investments - Short-term investments consisting primarily of U.S. Government and other investment grade securities are carried at fair value. Investment income or loss (including realized gains and losses, other than temporary unrealized losses, interest and dividends) is included in the excess of revenues over expenses. Unrealized gains and temporary unrealized losses are excluded from the excess of revenues over expenses and are shown as a change in unrestricted net assets.

Inventory of supplies - Inventory is valued based on the most recent price received.

Assets whose use is limited - These items consist of trustee held funds, investments in marketable equity and fixed income securities, mutual funds, investments in joint ventures, investments in expansion property and loans to others. Money market funds and all marketable securities have readily determined market values and are therefore carried at fair value. The investments in joint ventures and other are accounted for using the equity or cost method.

Property, plant and equipment - Property, plant and equipment are stated at cost. Improvements and replacements of plant and equipment are capitalized. Maintenance and repairs are expensed as they are incurred. When property, plant and equipment is sold or retired, the cost and the related accumulated depreciation are removed from the accounts, and the resulting gain or loss is recorded.

Medical office buildings and other - These properties consist of medical offices and other rental buildings and land held for future development. These assets, other than land, are depreciated using the straight-line method over periods of 3 to 40 years.

Depreciation - Depreciation on property, plant and equipment is computed using the straight-line method over the following estimated useful lives:

Land improvements	5 - 20 years
Buildings and improvements	5 - 50 years
Fixed equipment	10 - 25 years
Leasehold improvements	Shorter of remaining length of the lease or useful life
Moveable equipment	3 - 15 years

Deferred financing costs - These costs are amortized over the lives of the related debt issues using the straight-line method which approximates the effective interest method.

Other assets – Goodwill recorded in connection with the purchase of certain assets is included in other assets. Goodwill is amortized using the straight-line method over its estimated useful life of two to five years. Other assets also includes the cash surrender value of life insurance on various employees in the Corporation and unvested deferred compensation and had a carrying value of approximately $18,787,000 and $15,884,000 as of June 30, 2006 and 2005, respectively.

Donations and grants - Unrestricted donations and grants are recorded as other operating revenues. Donor-restricted donations and grants are recorded as additions to the appropriate class of net assets. When capital expenditures are made consistent with the purpose intended by the donor, a transfer is made from temporarily restricted net assets to unrestricted net assets. If restricted amounts are expended for operations, the amounts are recorded as other operating revenues in the accompanying consolidated statements of operations.

Interest in Net Assets of Related Foundations - The Corporation accounts for activities with its related foundations under Statement of Financial Accounting Standards No. 136, "Transfers of Assets to a Not-For-Profit Organization or Charitable Trust That Raises or Holds Contributions for Others" (SFAS 136). SFAS 136 requires the Corporation to recognize its interests in the net assets of its related foundations.

Recently Adopted Accounting Standards - In March 2005, the Financial Accounting Standards Board (FASB) issued Interpretation No. 47 (FIN 47), "Accounting for Conditional Asset Retirement Obligations", an interpretation of FASB Statement No. 143 (SFAS 143). This interpretation clarified that an entity is required to recognize a liability for the fair value of a conditional asset retirement obligation if the fair value of the liability can be reasonably estimated. Uncertainty about the timing and (or) method of settlement of a conditional asset retirement obligation should be factored into the measurement of the liability when sufficient information exists. The types of asset retirement obligations that are covered by FIN 47 are those for which an entity has a legal obligation to perform an asset retirement activity. However, the timing and (or) method of settling the obligation are conditional on a future event that may or may not be within the control of the entity. SFAS 143 requires the fair value of a liability for a legal obligation associated with an asset retirement be recorded in the period in which the obligation is incurred. When the liability is initially recorded, the cost of the asset retirement is capitalized.

The Corporation adopted FIN 47 effective June 30, 2006 and recorded a liability of $13,511,902 which is included in other liabilities in the accompanying consolidated balance sheets, of which $11,537,949 was recorded as a cumulative effect of a change in accounting principle. Since SFAS 143 requires retrospective application to the inception of the liability, the initial asset retirement obligation was calculated using a discount rate of 5.15%, which approximates the Corporation's weighted average cost of capital at June 30, 2006. The cumulative effect of the adoption of FIN 47 reflects the accretion of the liability and the depreciation of the related asset component from the liability inception date through June 30, 2006.

Substantially all the impact of adopting FIN 47, as described above, relates to estimated costs to remove asbestos that is contained within the Corporation's facilities. The additional depreciation and accretion costs in fiscal 2007 are expected to be approximately $833,000.

Net patient service revenues - The Corporation has agreements with third party payers that provide for payments of amounts different from established charges. The Corporation's net patient service revenue came from the following sources:

	2006	2005
Medicare	36.9%	36.6%
Medicaid	8.2%	8.4%
Commercial & Other	50.0%	51.0%
Private Pay	4.9%	4.0%
	100%	100%

The Corporation has estimated payments for services rendered to Medicare and Medicaid patients during the year by applying the payment principles of the applicable governmental agencies and believes that an adequate provision has been made in the accompanying financial statements for final settlement. Estimates of final settlements to Medicare, Medicaid and other third party payers have been reflected as a reimbursement settlement payable in the accompanying consolidated balance sheets. Differences between the net amounts accrued and subsequent settlements are recorded in operations at the time of settlement.

Reimbursement for inpatient services rendered to Medicare recipients has been made principally under a prospective pricing system based on diagnosis-related groups. Most outpatient services provided to Medicare patients are reimbursed based on prospectively determined rates.

Services to Medicaid patients are reimbursed based on a combination of prospectively determined rates and cost reimbursement methodology.

Continuation of these reimbursement programs at the present level, and on the present basis, is dependent upon future policies of federal and state governmental agencies.

The Corporation has also entered into payment agreements with certain commercial insurance carriers, health maintenance organizations and preferred provider organizations. The basis for payment to the Corporation under these agreements includes prospectively determined rates per unit of service and discounts from established charges. Most arrangements provide for payment or reimbursement to the Corporation at amounts different than established rates. Contractual discounts represent the difference between established rates for services and amounts paid or reimbursed by these third-party payers.

Other operating revenue - Other operating revenue includes revenue from nonpatient care services, clinical space rental revenues and donations to support operating activities.

Federal and State income taxes - The Corporation has received a determination letter from the Internal Revenue Service stating that it is exempt from Federal income tax under Section 501(c)(3) of the Internal Revenue Code except for tax on unrelated business income. It is management's belief that none of its activities have produced material unrelated business income.

Reclassifications - Certain reclassifications have been made to prior year amounts to conform to the current year presentation to more consistently present financial information between years.

3. Investments

Assets Whose Use is Limited

The composition of cash and investments included in assets whose use is limited at June 30, 2006 and 2005, is set forth in the following table. Investments are stated at fair value.

	2006	2005
Designated for capital acquisition:		
Cash and short-term investments	$218,939,060	$6,578,718
Fixed income	114,777,716	211,236,969
Equity securities	125,052,360	205,428,575
	458,769,136	423,244,262
Trustee held funds:		
Cash and short-term investments	22,597,389	11,445,203
Fixed income	18,564,472	123,333,749
Equity securities	28,472,852	26,883,060
	69,634,713	161,662,012
Other investments:		
Cash and short-term investments	1,227,888	822,983
	$529,631,737	$585,729,257

Investment earnings on assets whose use is limited are comprised of the following for the years ended June 30, 2006 and 2005.

	2006	2005
Included in investment income:		
Interest income	$24,054,627	$16,798,129
Net realized gain (loss) on sales of investments	20,309,277	(1,458,316)
	$44,363,904	$15,339,813
Included in changes in unrestricted net assets:		
Change in net unrealized gains / losses on assets whose use is limited	$(1,672,842)	$18,825,725

Securities Lending Agreements

The Corporation has entered into a securities lending agreement whereby a portion of investments are loaned to various brokers in return for cash and securities from the broker as collateral for the securities loaned. Pursuant to the agreement, the collateral received must always equal at least 102% of the fair value of the securities loaned, which is determined at the end of each business day. The securities on loan are comprised entirely of fixed income securities.

4. Charity care

The Corporation maintains records to identify and monitor the level of charity care it provides. Charges forgone for services and supplies furnished under the charity care policy for the years ended June 30, 2006 and 2005 were approximately $57,734,000 and $49,482,000 respectively.

5. **Accounts receivable**

Accounts receivable at June 30 consisted of the following:

	2006	2005
Patient accounts receivable	$257,913,745	$237,855,414
Less:		
Allowance for doubtful accounts	(47,118,466)	(45,860,968)
Allowance for estimated contractual discounts	(74,774,910)	(64,264,418)
Net patient accounts receivable	136,020,369	127,730,028
Other accounts receivable	1,108,021	5,644,643
Accounts receivable, net	$137,128,390	$133,374,671

6. **Long-term debt**

Long-term debt at June 30 consisted of the following:	2006	2005
Series 1993 Washington Bonds, variable interest rate, (3.98% at June 30, 2006) payable each April 1, due in annual installments through 2018, maturing April 1, 2018.	$17,300,000	$18,200,000
Series 1994 Washington Bonds, 5.30%, interest payable each March 1 and September 1, due in annual installments through 2009, maturing March 1, 2009.	3,510,000	4,565,000
Series 1994 Oregon Bonds, 5.625%, interest payable each February 1 and August 1, due in annual installments through 2007, maturing August 1, 2007.	5,100,000	7,450,000
Series 1995 Oregon Bonds, variable interest rate, (3.95% at June 30, 2006) payable each December 1, due in annual installments through 2015, maturing December 1, 2015.	10,185,000	10,925,000
Series 1995 Washington Bonds, 5.00% to 5.625%, interest payable each May 15 and November 15, due in annual installments through 2015, maturing November 15, 2015. Advance refunded during 2006.	-	20,045,000
Series 1998 Washington Bonds, 5.00%, interest payable each May 15 and November 15, due in annual installments through 2028, maturing November 15, 2028. Advanced refunded in 2006.	-	60,000,000

Series 1998 Oregon Bonds, variable interest rate, (3.95% at June 30, 2006) payable each December 1, due in annual installments through 2028, maturing December 1, 2028.	13,200,000	13,500,000
Series 2001 Washington Bonds, variable interest rate, (3.35% on $40 million and 3.70% on $40 million, at June 30, 2006) payable each November 15, due in annual installments from 2016 to 2032, maturing November 15, 2032.	80,000,000	80,000,000
Series 2001 Oregon Bonds, 5.00% to 5.25%, interest payable each May 15 and November 15, due in annual installments from 2017 to 2032, maturing November 15, 2032.	70,000,000	70,000,000
Series 2004 Oregon Bonds, Series A ($15,000,000) 3.00% to 5.00%, interest payable each February 1 and August 1, due in annual installments from 2010 to 2014. Series B-F ($193,350,000), variable interest rate (3.50% to 3.80% at June 30, 2006), due in annual installments from 2008 to 2019 and from 2030 to 2034, maturing August 1, 2034.	208,350,000	208,350,000
Series 2005 Washington Bonds, variable interest rate, (3.95% on $42.7 million and 3.85% on $43.3 million at June 30, 2006), principle payable each October in annual installments through 2028.	86,000,000	-
Other long-term debt	6,900,747	8,013,983
Total long-term debt	500,545,747	501,048,983
Less amounts due within one year	(6,858,458)	(7,845,056)
Total long-term debt due after one year	$493,687,289	$493,203,927

The Series 1993 Washington, 1995 Oregon, 1998 Oregon, 2001 Washington bonds and a portion of the 2004 Oregon bonds have variable interest rates that may bear interest at a daily, weekly, 28 day, monthly, semi-annual, annual or fixed rates. The rate determination mode may be changed upon request of the Corporation. The bonds are subject to optional redemption by PeaceHealth, in whole or in part at 100% of the principal amount plus accrued interest. The Corporation has a standby bond purchase agreement or letter of credit agreement for the 1993, 1995 and 1998 variable rate demand bonds for the amount of the outstanding principal plus accrued interest. The 2001 auction rate bonds do not require a standby bond purchase agreement. The Series 2004 Oregon bonds consist of six series of bonds, five of which are auction rate bonds with a total par amount of $193,350,000 that have fixed payer swaps associated with them with rates ranging from 3.23% to 3.69%, and $15,000,000 of traditional fixed bonds that have coupons which range from 3.00% to 5.00%, which in aggregate were priced to yield 3.3%. The 2005 Washington bonds consist of two series of bonds that have fixed payer swaps associated with them which pay 3.281%.

During 2006, the Corporation advanced refunded the $60,000,000 Series 1998 Washington Bonds, and refinanced the remaining $18,655,000 of the Series 1995 Washington Bonds by issuing the 2005 Washington bonds in the amount of $86,000,000 which resulted in a loss on refinancing of $6,667,691. The loss on refinancing consists of $2,965,591 of unamortized financing costs associated with the refinanced bonds and $973,100 of call premiums and $2,729,000 of defeasance costs. This loss on refinancing is included in other non-operating income in the accompanying consolidated statement of operations in 2006. As of June 30, 2006, $60,000,000 of the advance refunded bonds, which are considered extinguished, remain outstanding.

During 2005, the Corporation refinanced $46,250,000 of the outstanding amount of the Series 1994 Oregon Bonds (the 1994 bonds) which resulted in a loss on refinancing of $2,194,474. The loss on refinancing consists of $1,269,474 of unamortized financing costs associated with the refinanced 1994 bonds and $925,000 of call premium and has been included in other non-operating income in the accompanying consolidated statement of operations in 2005.

In accordance with the requirements of the Bond Trust Indentures at June 30, the following funds were held by trustees:

	2006	2005
Principal, interest and other funds	$3,093,846	$6,490,505
Project funds	15,568	96,589,762
Debt service reserve funds	1,305,527	1,311,861
	$4,414,941	$104,392,128

These trustee-held funds are included in assets whose use is limited in the accompanying consolidated balance sheets.

The Master Trust Indenture, the loan agreements and other contractual documents under which the Corporation's bonds were issued include covenants, which among others, obligate the Corporation to: maintain net patient service revenues at levels sufficient to achieve specified debt service coverage ratios; meet certain financial tests before additional debt can be incurred; and to meet certain financial tests before there can be any significant disposition of property.

Scheduled aggregate maturities of long-term debt subsequent to June 30, 2006 are as follows:

Year ending June 30	
2007	$ 6,858,458
2008	7,303,076
2009	4,963,456
2010	6,465,323
2011	5,999,249
Thereafter	468,956,185
Total	$500,545,747

Cash paid for interest totaled approximately $20,142,000 and $19,833,000 for the years ended June 30, 2006 and 2005, respectively. Interest totaling approximately $2,413,000 and $1,278,000 was capitalized in connection with construction projects during the years ended June 30, 2006 and 2005, respectively.

7. Accounting for derivative instruments and hedging activities

In accordance with the policy adopted by the Board of Directors, the Corporation may use interest rate swap contracts to manage its net exposure to interest rate changes in attempting to reduce its overall cost of borrowing over time. Interest rate swap contracts generally involve the exchange of fixed and floating interest rate payments without the exchange of underlying principal (the swap of fixed or floating rates are on a "notional" amount). The Corporation accounts for its interest rate hedging transactions in accordance with Statement of Financial Accounting Standards No. 133 (SFAS 133) "Accounting for Derivative Instruments and Hedging Activities". The standard requires that every derivative instrument be recorded on the balance sheet as either an asset or liability measured at its fair market value. The standard requires that changes in the derivative instrument's fair market value be recognized currently in earnings unless specific hedge accounting criteria are met. Accounting for qualifying fair value hedges allows a derivative instrument's gains and losses to offset related results on the hedged item in the statement of operations, to the extent effective, and for qualifying cash flow hedges the change in the value of the swap to be reported as a component of changes in net assets. The Corporation has formally documented, designated and assessed the effectiveness of transactions that receive hedge accounting treatment.

The Corporation has entered into various interest rate management transactions as of June 30, 2006 with a total notional amount of $319,350,000, which included the following: a basis swap on $40,000,000 of variable rate bonds which exchanges the interest rate paid from one variable rate to another, $193,350,000 of cash flow hedges (fixed payer swaps) which convert variable rates to fixed rates for the 2004 Oregon bonds and $86,000,000 of cash flow hedges (fixed payer swaps) related to the 2005 Washington bonds.

The Corporation evaluated the fixed payer swaps and determined that they meet the criteria for hedge accounting in the accompanying financial statements. Using the criteria required by SFAS 133, the Corporation determined that of the approximate $27,200,000 increase in fair value of the cash flow hedges in fiscal 2006, approximately $6,200,000 of the increase was due to hedge ineffectiveness and therefore was recorded as a reduction in interest expense on the Statement of Operations. The remaining approximate $21,000,000 was accounted for as an increase in unrestricted net assets. In fiscal 2005, these cash flow hedges experienced a decrease in fair value of approximately $20,410,000, all of which was accounted for as a decrease in unrestricted net assets as hedge ineffectiveness was nominal.

The basis swap does not qualify for hedge accounting treatment and its change in market value and associated cash flows are included as a component of interest expense which amounted to a reduction in interest expense of $1,662,000 in fiscal 2006, and additional interest expense in the amount of $822,000 in fiscal 2005.

All of the outstanding interest rate swap transactions allow the Corporation to terminate the financial instruments by requiring full settlement of any interest or termination value, upon 10 days notice given on the first business day of each month. The counterparty can terminate the swaps, requiring full settlement of any interest or termination value, only if the Corporation's credit rating falls to BBB- or equivalent.

In measuring the swaps at fair value, the Corporation has recorded a net asset of $12,936,000 and a net liability of $15,771,000 as of June 30, 2006 and 2005, respectively, which has been recorded in other assets and other liabilities, respectively, in the accompanying consolidated balance sheets.

8. Medicare and Medicaid revenue

Net revenue for services provided to Medicare patients for the years ended June 30, 2006 and 2005 was approximately $374,588,000 and $348,796,000 respectively. Medicaid net patient service revenue for the years ended June 30, 2006 and 2005 was approximately $82,796,000 and $80,450,000 respectively. Laws and regulations governing the Medicare and Medicaid programs are extremely complex and subject to interpretation. As a result, recorded estimates may change by a material amount in the near term. Adjustments from finalization and adjustment of prior years cost reports and other third-party settlements resulted in an increase in net patient service revenues of approximately $3,001,000 and $10,900,000 for the years ended June 30, 2006 and 2005, respectively.

The Medicare cost reports are subject to retroactive adjustment for three years after settlement, unless held open longer for disputed items. The reimbursement reports receive either full or limited scope audits by the fiscal intermediary appointed by Medicare. Settlements for open years will be finalized after review by the appropriate government agencies.

9. Restricted net assets

Restricted net assets are those whose use by the Corporation has been limited by donor imposed restrictions to a specific time period and/or purpose. Permanently restricted net assets have been restricted by donors to be maintained in perpetuity.

Temporarily and permanently restricted net assets are available for the following purposes at June 30:

	2006	2005
Purchase of property, plant and equipment	$28,297,851	$22,271,306
Indigent care	255,359	285,321
Patient care operating activities	4,093,864	3,818,630
Other	199,645	211,024
	$32,846,719	$26,586,281

During fiscal year 2006 and 2005, net assets were released from donor restrictions by incurring operating expenses satisfying the restricted purposes of approximately $359,000 and $696,000, respectively. Further, approximately $2,466,000 and $1,454,000 of capital expenditures were made during 2006 and 2005, respectively, that met the guidelines stipulated for reimbursement from donated funds.

10. Retirement plan

The Corporation has a defined contribution retirement plan which covers substantially all employees meeting certain age and length of service requirements. Total retirement plan costs charged to operations were approximately $26,495,000 and $25,118,000 for the years ended June 30, 2006 and 2005, respectively and are included in payroll taxes and benefits in the accompanying consolidated statements of operations.

11. Antitrust judgment

The Corporation was sued by McKenzie-Willamette Hospital of Springfield, Oregon in the federal district court for the district of Oregon. The claims included violation of federal antitrust and other laws. After trial on the money-damages portion of the lawsuit, the jury returned a verdict in favor of the plaintiff on the following three of the seven claims it had alleged: attempted monopolization, price discrimination and wrongful interference. The jury awarded alternative damages, and McKenzie-Willamette Hospital elected damages in the amount of $5.4 million, which if upheld will be trebled in accordance with the antitrust law (total of $16.2 million). The court has entered a judgment on the verdict, which is currently under appeal by the Corporation with the 9th Circuit Court of Appeals. Because of the uncertain nature of litigation assessments, in 2005 the Corporation recorded a liability for the full amount of the damages, including interest, but it intends to aggressively pursue the appeal based on the opinion of counsel that error was committed at the trial court level. The non-monetary portion of the case which sought equitable relief has been fully settled for a nominal amount.

12. Commitments and contingent liabilities

The Corporation leases, for a nominal amount, the buildings and certain equipment for Ketchikan General Hospital from the City of Ketchikan, Alaska under a ten-year lease which expires in 2013.

The Corporation has begun a project to improve its current facilities and construct a replacement facility for a substantial portion of services for Sacred Heart Medical Center which is part of its Oregon Region. The Corporation has spent approximately $149.5 million as of June 30, 2006 and expects the entire project to cost over $ 645.9 million and extend through fiscal year 2008. The Corporation has entered into construction and other commitments for approximately $233.4 million as of June 30, 2006 related to this project.

The healthcare industry is governed by various laws and regulations of federal, state and local governments. These laws and regulations are subject to on-going government review and interpretation, as well as regulatory actions unknown or unasserted at this time. The Corporation is also involved in litigation and regulatory investigations arising in the course of business. After consultation with legal counsel, management estimates that these matters will be resolved without material adverse effect on the Corporation's future financial position or results from operations.

13. Insurance coverages

The Corporation has a self-insurance program for hospital and physician professional and general liability claims under which the Corporation contributes actuarially determined amounts to a trust to fund estimated ultimate losses. In connection with the self-insurance program, the Corporation has accrued estimates for asserted and incurred but not reported claims. The claims liability has been discounted to present value using a discount rate of 6%. Self-insured professional and general liability retention in 2006 and 2005 was $5,000,000 per occurrence and $18,000,000 in aggregate. Individual general and professional liability claims in excess of the above self-insured retention levels are insured through a claims made excess insurance policy (note 1).

The Corporation also self-insures all or a portion of liabilities related to its medical and dental benefit plans, unemployment and worker's compensation claims. Funding levels are determined based on an actuarial study.

Funded amounts for all self-insured plans, $65,170,000 at June 30, 2006 and $56,825,000 at June 30, 2005, are held in trust and are included in assets whose use is limited in the accompanying consolidated balance sheets. The self-insurance reserve is included in other long-term liabilities on the consolidated balance sheets.

14. Fair value of financial instruments

At June 30, 2006 and 2005, the Corporation's carrying amount and fair value of financial instruments were as follows:

	2006		2005	
	Carrying Value	Fair Value	Carrying Value	Fair Value
Short-Term Investments	$111,853,183	$111,853,183	$76,414,366	$76,414,366
Securities Lending Agreements	60,228,138	60,228,138	109,427,291	109,427,291
Limited Use Investments	529,631,737	529,631,737	585,729,257	585,729,257
Loans Receivable	1,999,941	1,944,277	1,809,503	1,853,829
Long-Term Debt	500,545,747	501,435,477	501,048,983	509,352,435

Cash and Cash Equivalents - The carrying amount approximates fair value because of the short maturity of those instruments.

Investments - The fair value of investments equals quoted market price. If a quoted market price is not available, fair value is estimated using quoted market prices for similar securities.

Loans Receivable - The fair value is estimated by discounting future cash flows using the current rate at which similar loans would be made to borrowers with similar credit ratings and for the same remaining maturities.

Securities Lending Agreements - The carrying amount approximates fair value because of the short maturity of those instruments.

Long-Term Debt - Rates currently available to the Corporation for debt with similar terms and remaining maturities are used to estimate fair value of debt.

Financial Derivatives – The fair value of derivative financial instruments are developed from quoted market prices for similar instruments (note 7).